

Mortgage lending and macroprudential policy in the UK and US

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This thesis draws on both my own experience and research over several decades in financial regulation and policy formation and implementation. It develops the thoughts and views of a number of senior officials in government, regulation, politics and the financial services industry. I am grateful for their cooperation and the frankness with which they expressed their opinions which were all provided on the understanding that they were speaking in a personal capacity and that what was said would not be attributed.

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Abstract

For many decades both UK and US politicians have encouraged homeownership supported by mortgage lending. Exuberant borrowing has fuelled housing booms and is central to many recent financial problems. As a consequence macroprudential policies have been developed to improve financial stability using a mixture of measures to deter excessive lending including loan-to-value and debt-to-income restrictions. This thesis considers macroprudential policymaking generally and, more specifically, this latter group of macroprudential measures.

It concludes that it is unlikely that these measures can be used to any significant extent in western democracies. At its heart is their political legitimacy and the potential consequences for the institutions promulgating

such policies since a major use of these limits would have a direct and very visible effect on home ownership aspirations. Further, the evidence indicates that these measures may well be ineffective.

This thesis suggests that conduct of business regulatory policy and the use of mortgage affordability verification may be more effective. However, the successful employment these measures for macroprudential purposes may be hindered by the structure of UK financial services regulation. Moreover, there is a challenge in that historically, UK conduct of business regulation has often failed. Nevertheless, in the area of mortgage affordability, there may be opportunities to use innovative regulatory policies to reduce these risks going forward.

Further, there may be lessons for the UK from the US's approach of using the concept of the "qualified mortgage" and, additionally, in considering the role of sound conduct of business policies such as those are used by the US Veterans Administration.

Nevertheless, the failure to build sufficient homes over the last forty years is at the heart of UK financial instability. Macroprudential policy may have the unequal task of attempting to suppress house price booms. This raises political issues and highlights the constraints on macroprudential policy with limits on its ability to influence fiscal and socio-economic policy. This thesis seeks to influence the debate on what can be done to help to ensure financial stability.

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Chapter 1

Introduction

“Undone by mortgages”¹

“Only by owning land will they respect the property of others”²

In 1896, the architect Hermann Muthesius joined the German embassy in London as a special attache with a brief to report on British housing. He wrote to the Grand Duke Carl Alexander of Saxe-Weimar stating "no nation has identified itself more with the house."³ The UK, more recently has been described as a “nation bewitched by property...home-ownership still stands its ground along with weather...as Britain's public conversation of choice. House price surveys...command the front page; while the TV schedules are dominated by the generic pap of Location, Location, Location, Property Ladder, Trading Up or, for the more aspirational, Grand Designs.”⁴ As seen in the quotation at the start of this chapter the great European statesman and first president of Greece identified that having a home was desirable to help ensure political stability. Home ownership has been described as “a source of personal identity and status”; providing “a sense of place and belonging”.⁵ It can establish both memory and hope. Over the last hundred years this has become central to UK socio-political understanding with a popular demand for housing and the security this is thought to bring.

¹ Richard Brome, “*The English moor*”, (published 1640, University of Missouri Press, Columbia, 1984), Rashley, Act 1, Scene 1

² Ioannis Kapodistrias, Letter to A. M. le Chevalier Eynard, February 1830, ‘Correspondence de Comte Kapodistrias’, (1839), 3, Geneva, 472-473, Bibliothèque Université De Genève

³ Quoted by Tristram Hunt MP during the debate on the Housing and Planning Bill, 2nd November 2015, Hansard, column 777

⁴ Tristram Hunt, ‘How the English became obsessed with property’, (New Statesman, 2nd February 2004)

⁵ Shelley Mallett, ‘Understanding home: a critical review of the literature’, (2004), *The Sociological Review*, 52(1), 63–89, 66

Residential housing mortgages have provided the fuel to satisfy this desire. This has been mirrored by the involvement of banks in housing finance in, for example, the US since the 1920s and in the UK from 1970s. This has changed the composition of bank lending and balance-sheets. The rapid growth in this lending was at the heart of the recent financial crisis in the UK and in a number of other countries. The consequential financial instability threatened not just the global financial system but has spread to the “real” economy and is likely to have had a significant influence on the political system.⁶

As a consequence, international cooperation and national initiatives have developed macroprudential policymaking to improve financial stability. These steps have both measured and highlighted risks to financial stability and implemented actions to help to reduce these risks. The latter policies broadly fall into two groups of instruments or “tools”: those that seek to reduce banking lending by increasing the cost to banks of rapidly increasing credit, and those that placed quantitative restrictions on such lending particularly for house purchases.

Many of these actions mirror those employed by microprudential supervisors. In addition, both macroeconomic and fiscal policies may also have macroprudential effects. This thesis considers these aspects in relation to residential mortgages and their respective relationships and merits. It does not cover areas such as “buy-to-let” or “equity release” since these types of transactions have their own dynamics and operate in ways which are more akin to investment products.

Central to this work are questions relating to the quantitative measures, such as loan-to-value (LTV) and debt-to-income (DTI) restrictions, and whether these can be used to any significant extent in western democracies and, if employed, whether they are likely to be effective. At its centre is their political legitimacy and the potential consequences for the institutions promulgating such policies.

The answer, at least in part, may exist in a different area of regulation: that regulating conduct of business. The recent financial crisis revealed serious deficiencies in the conduct of mortgages sales both in the US and UK. Superficially, both responded with

⁶ Guillermo Cordero and Pablo Simón, ‘Economic crisis and support for democracy in Europe’, (2016) *West European Politics*, 39:2, 305-325, 317. See also Matthew Goodwin, ‘The Great Recession and the rise of populist Euroscepticism in the United Kingdom’ in Hanspeter Kriesi and Takkis Pappas (eds), *European populism in the shadow of the great recession*, (ECPR Press, Colchester, 2015), 273-286, 281-284

similar sets of new regulations. However, the underlying regulatory concepts were different. The US focus is on standardising the structure of mortgages to make it easier for customers to understand and to compare mortgage offers. The UK's approach is much more paternalistic evidencing a lack of trust in the consumer's judgement with new regulations designed to protect the customer from themselves.

Accepting that conduct of business regulation in the UK has its limitations and has suffered many substantial failures, this thesis proposes that it may still provide a more effective alternative to reliance on LTV and DTI measures to curb a mortgage lending bubble.

However, UK regulation in this area could benefit from incorporating some aspects of the US's approach. The regulation of mortgage selling in the UK has followed a path set in the 1980s, largely designed to protect wealthy customers from abuse by their trusted investment advisers. There are limitations to this approach and US financial services' policymaking could provide innovative examples for use in the UK. This thesis highlights three particular aspects.

First, the US "qualified mortgage" is a largely unknown concept in the UK. This provides a mechanism for policymakers, including politicians, to set limits to the public "risk appetite", balancing consumer protection, ensuring financial stability and meeting societal expectations and aspirations. Second, there does not appear to have been any assessment of the role of sound conduct of business policies employed by, for example, the Veterans Administration (VA), a significant Government Sponsored Enterprise (GSE), during the financial crisis. Where other GSEs, such as Fannie Mae and Freddie Mac, failed and were rescued by the Federal government the VA was unaffected and prospered, as did those borrowers it served. It is possible that the VA's support for mortgages was successful for reasons other than good conduct of business policies but this is an aspect which merits further research. Additionally, there is scope for much greater, and possibly more effective, innovative regulatory policy in this area by making use of the extensive data available on potential borrowers rather than the current reliance on long customer interviews examining sources of income and the customers' assessment of their expenditure and future intentions.

Conduct of business policy in this area may be hampered by the structure of regulation in the UK. Macroprudential policymaking is undertaken within the Bank of England while

conduct of business policy is the responsibility of the Financial Conduct Authority. Moreover, it is not entirely clear that the macroprudential policymakers fully understand the difference between credit and affordability risk and the importance of this distinction for both conduct of business and macroprudential policy. This issue and the results of interviewing senior current and former regulators indicate a possible disjunct between the two sets of policymakers and how conduct of business policy, in relation to mortgages, may provide important support for macroprudential policies.

As mentioned, the rapid expansion of credit to support house purchases has been central to almost all financial crises particular in the latter part of the 20th and early years of 21st centuries. This may be due to a variety of reasons including increasing household formation, ready access to credit and cultural norms.⁷ For example, Germany has one of the lowest homeownership rates in Europe.⁸ This appears largely due to a well-developed private rental sector and high levels of tenant protection with modest rent rises, many of which are subject to statutory controls. In the UK, however, since the financial crisis the option of owning a home of ones' own has faded for those who currently do not have sufficient funds to put down a large deposit and cannot prove that they can afford a mortgage.⁹

Macroprudential policy may have the unequal task of attempting to suppress house price booms as it seeks to maintain a lid on the pressure cooker of an asset bubble. Moreover, macroprudential policy is predicated on its ability to identify sufficiently early potential risks to financial instability and root causes and to deploy the necessary macroprudential tools in time and to effect. The evidence that this would happen is not robust. Further, in the UK a major reason for such a high demand for housing, house price inflation and rapid credit creation is the significant deficit in the supply of housing. Government policy in this area

⁷ Germany provides an interesting comparison. Germans continue to save rather than consume. However, equity investments are seen as too volatile and bank and savings deposits, the traditional place for German savings, continue to have very poor rates of return. However, based on anecdotal information, Germans continue to rent since rent increases are controlled and tenancies are long-term and heavily protected. However, moving to a new tenancy can be very expensive so most Germans simply do not move. Instead, many are using their savings to buy new properties which they let out in turn, which provides a much higher and stable rate of return. German households own 75% of all housing but only 43% live in their own homes. The balance is rented out by one household to another, European Central Bank, 'Housing finance in the Euro area', (March 2009) Occasional Paper Series, No. 101, 34

⁸ Eurostat, Housing statistics, Eurostat, Eurostat, http://ec.europa.eu/eurostat/statistics-explained/index.php/Housing_statistics#Tenure_status (accessed 2nd March 2017)

⁹ Daily Telegraph, *"Is the British dream of home ownership dead?"*, (3rd January 2015)

has, at the very least, failed to support macroprudential policy and may be running counter to its objectives. This highlights the constraints on macroprudential policy since there are significant limits on its ability to influence fiscal and socio-economic policy.

The results of my research in preparing this thesis have been used to prepare a response to the January 2017 White Paper on housing. Additionally, it has been used as part of a submission both to the Shadow Housing Minister and the Labour House of Lords spokesman on housing for inclusion in the May 2017 election manifesto. It has also formed the basis for a number of discussions with senior policy staff at the Bank of England and Financial Conduct Authority.

In summary, although discussions on macroprudential policy go back to at least the early 2000s the difficulties inherent in this form of regulation, coupled with a reluctance to interfere when asset prices rose rapidly, meant that it took the recent financial crisis for its importance to be fully recognised. Macroprudential policy is at a very early stage. Nevertheless, there is a danger that it may become too narrowly focused. To avoid this happening it needs to address, both conceptually and operationally, a range of issues. These include: the political and institutional legitimacy of macroprudential policy; how it relates to microprudential and conduct of business regulation; the need to manage excessive expectations; and recognition that any belief that macroprudential policy can be “fine-tuned” is a chimera. At the same time macroprudential policy has a tendency to expand its scope as risks are perceived to migrate from one area to the next.

Further, macroprudential authorities need to consider the wider economic and societal issues and the effectiveness of some of the macroprudential tools and their potential for unintended consequences. Finally, it is possible that LTV and DTI limits may simply not work in the face of market forces, political interference and the lack of any willing constituency reinforcing such measures. It is possible that too many expectations are balanced on the columns of macroprudential policy while the countervailing forces of monetary policy and political expediency may help to create instability in the structure.

Consequently, macroprudential policy needs to be subject to realistic expectations with limited “role responsibility creep” and policymakers need to reinforce the public and political legitimacy of their role. Moreover, macroprudential policy needs to be coordinated with monetary and fiscal policy. Finally, it should not neglect the importance of conduct of

business affordability assessment regulations in helping to contain the growth of credit in the economy.

Chapter 2 examines the importance of financial stability and the geopolitical concept of the “turbulent frontier” applied to macroprudential policy. It is likely that the latter will be extended to encompass one aspect of the economy after another, and complicate its relationship with macroeconomic, microprudential and fiscal policies.

Chapter 3 is focused on the quantitative macroprudential tools restricting mortgages for housing, their use in Asia in the 1990s and more recently in other jurisdictions and the reasons militating against success as the markets find ways of circumventing its effect.

Chapter 4 considers UK conduct of business and mortgage regulation including its path-dependency and also the effect of work on behavioural economics and increased regulatory paternalism in the development of regulatory policy. The chapter also examines some of the societal effects of mortgage affordability assessment regulation.

Chapter 5 assesses US mortgage conduct of business regulatory policy since the recent financial crisis and its vulnerability both to reliance on the provision of information to borrowers and the weakness in regulatory policy governing mortgage intermediaries and contrasts this with the approach taken in the UK. Further, the US “qualified mortgage” is an approach unknown in the UK and this chapter considers whether the UK could adopt the concept as a means of limiting the risk of over-selling mortgage credit.

Chapter 6 considers the very real problems of expanding macroprudential policy, in particular those with quantitative effects, since these policies start to encroach on the role of the elected government and may challenge the political legitimacy of macroprudential policymakers. The latter are very conscious of this issue and in the UK have tried to shy-away from employing effective macroprudential tools in this area.

Chapter 7 examines US Federal intervention in the housing market and considers the success of the Veterans Administration (VA) and its employment of conduct of business policies which may have been responsible for protecting borrowers, the VA and significant elements of the economy from failures in this area during the financial crisis. This may

support the use of such measures both for consumer protection and as instruments of macroprudential policy.

Chapter 8 returns to the central issue that the propensity to over-borrow to buy a home is implicit in the UK economy both for cultural reasons and due to the significant lack of house building in the UK since the early 1980s. Unless this issue is addressed with a significant home building programme the country will continue to face the risk of a financial crisis every few years and macroprudential policy will have to be developed to continue to suppress increasing demand for mortgages to finance the purchase of the scarce resource of housing.

During the course of researching this thesis my views were subject to a complete volte-face. I started with the conviction that quantitative macroprudential instruments, such as LTV and DTI limits, were the answer to rapid credit growth and that conduct of business policy had only a limited role to play. This more or less reflected the conventional view. My research convinced me otherwise. This thesis explores this conceptual journey and reveals the difficulties faced by UK macroprudential policymakers in the UK without a significant effort to revise housing policy.

In conclusion it is evident that macroprudential policy operates at the point where law, economics and politics intersect. The consequences are that quantitative macroprudential policy tools may be ineffective in the face of market forces and if employed to any significance extent may undermine the legitimacy of the macroprudential policymakers. Nevertheless, it may be possible to learn from other jurisdictions and to consider the employment of measures such as “qualified mortgages” and more innovative methods for assessing mortgage affordability and to operate conduct of business policy in coordination with macroprudential objectives. In addition, politicians need to understand the implications of a lack of significant housebuilding not just in societal terms but also the threat it poses for financial stability.

Methodology

Two key methodologies have been adopted in researching this thesis: an examination and analysis of original sources including legislations, regulatory consultations, policy documents and reports and assessments of these policies and their implementation and, second, interviews with both current and former senior policymakers and regulators, representatives of both professional and industry trade bodies, senior politicians and management at the major mortgage lenders. Additionally, I have used my own personal experience gained over some thirty years in the financial services world as a regulator, bank compliance director and policymaker.

As mentioned in the introduction, the focus of this thesis is on UK macroprudential and conduct of business policy in the residential mortgage market but includes aspects of US mortgage market practices and regulator policy and this is reflected in the documentation examined. The interviews include many of those involved in the UK, at a senior level, in the 2007/8 financial crisis and its aftermath together with those concerned with devising policy in areas related to housing and mortgages. Individuals at all the major lenders have been interviewed except for Royal Bank of Scotland who declined to assist in view of their current public ownership status.

Ethical consent to carry out the interviews was confirmed on 10th November 2015. All those interviewed are listed in Appendix II. All have been most helpful and forthcoming but, as agreed, their views have not been attributed.

Policymaking and regulation in the area encompassed by this thesis continue to change. For practical reasons this work is restricted to events, policies and regulations occurring before 1st February 2018.

Chapter 2

Macroprudential policies: rationale, scope and issues

“I would submit that the financial history of the last 40 years demonstrates that often when real estate operators are thrilled about credit availability, financial crisis is only a few years away.” - Larry Summers¹

“The state of knowledge about macroprudential regimes today is roughly where monetary policy was in the [1940s].” ²

2.1 Introduction

This chapter looks at the level of progress made in macroprudential policy since the 2007/8 crisis, with a particular focus on the role of credit and residential housing. This is important since it is widely acknowledged that the failure to have a broad regulatory and economic perspective across the economy and the consequential build-up of economic distortions was at the root of the recent financial crisis.³ Macroprudential policy aims to address this issue by taking an over-arching view of potential threats to financial stability and implementing actions to prevent these coming to fruition.⁴ Macroprudential policy comes in two main forms: narrow policies which seek to buttress the “resilience of the financial system” by building, for example, increased capital buffers and more widely-drawn policies which seek to damp-down a rapid expansion of credit.⁵ Nevertheless, it is worth noting that some consider that macroprudential policy, beyond a certain point, is a chimera since markets are too complex to map and comprehend and that action in

¹ Financial Times, ‘*There are big risks in a hasty rollback of financial regulation*’, (8th January 2017)

² Andrew Haldane, ‘Macroprudential policies - when and how to use them’, (April 2013), IMF seminar ‘Rethinking Macro Policy II: First Steps and Early Lessons’, Washington, DC

³ Charles Goodhart, ‘The macroprudential authority: powers, scope and accountabilities’, (2011) OECD Journal: Financial Market Trends, Issue 2, 5

⁴ Christian Noyer, ‘*Macroprudential policy: from theory to implementation*’, (April 2014) Banque de France, Financial Stability Review, No. 18, 7-11, 7

⁵ Emiliós Avgouleas, *Governance of global financial markets*, (Cambridge University Press, Cambridge, 2012), 268-269

response to macroprudential “signals” will be too slow.⁶ These are valid concerns, but the broad thrust of this thesis is that the consequences of inaction are worse and that there are effective mechanisms which can be employed to enhance and protect financial stability and which avoid some of the issues with macroprudential policy described in this chapter.

This chapter considers three broad themes: the relationship between credit growth, the housing market and the risk of financial instability; the purpose and role of macroprudential policy in curbing the growth of credit and protecting financial stability and the main issues with macroprudential policy. There are other possible perspectives. For example, Noyer concentrates on the important but more limited aspects of macroprudential policy governance and the identification of “market failures”.⁷ These are important aspects. However, this approach may be too narrow. This chapter highlights a significant element, encapsulated in the themes mentioned earlier, that it is important to broaden the view taken of macroprudential policy. Too narrow a focus may undermine the “legitimacy” of macroprudential policy, set unachievable expectations, produce unintended consequences and divorce it from its socio-economic context.

Initially, it is important to understand the objectives of macroprudential policy. Broadly, it can be said that the aim of macroprudential policy is to reduce serious systemic financial risk.⁸ The EU’s European Systemic Risk Board has defined macroprudential policy as: “contribute[ing] to the safeguard[ing] of the financial system as a whole, including by strengthening the resilience of the financial system and decreasing the build-up of systemic risks”.⁹ This chapter looks at aspects of these interpretations. It also considers what is encompassed by the phrase “systemic financial risk”. This analysis will include

⁶ Daniel Awrey, ‘Macroprudential financial regulation: panacea or placebo’, (2009) *Amsterdam Law Forum* Vol.1.3, 17

⁷ Noyer, *supra* note 4, 7

⁸ Steven Schwarcz, ‘Systemic risk’, (2008) 97 *Georgetown Law Journal* 193-249, 202, emphasises the importance of defining what needs to be controlled. There are a wide range of definitions. For example, the Basel Committee for Banking Supervision, ‘Core principles for effective banking supervision’, (2012), 2, defines macroprudential policy as, “applying a macro perspective to the microprudential supervision of banks ... to address systemic risk; and [measures to reduce]... both the probability and impact of a bank failure”

⁹ European Systemic Risk Board, ‘Recommendations on intermediate objectives and instruments of macroprudential policy’, (4th April 2013), ESRB/2013/1, 2013/C 170/01, Section 1. The Bank of England sees it as the: “remove[al] or reduc[tion] of systemic risks with a view to protecting and enhancing the resilience of the UK financial system”, ‘Instruments of macroprudential policy: A discussion paper’, (December 2011), 7. However, the IMF’s definition focuses more on the use of prudential tools, “Macroprudential policy [is] the use of primarily prudential tools to limit systemic risk”, ‘Key aspects of macroprudential policy’, (10th June 2013), 6

consideration of the structure of what is meant by the term “financial instability” and the development and objectives of macroprudential policy since “at the same time banking regulation needs to be cognizant of the effect of regulation on the wider economy”.¹⁰

This is particularly important since the nature of banking in the UK substantially changed in the 1970s. It reflected both a social and cultural turn as well as a transformation in financial markets regulation. These are often said to have started in the 1980s but the roots of these changes developed much earlier with banks starting to fund new asset classes coupled with a decline in class delineation in the structure of the banking industry.

The initial changes can be seen in the late 1960s and early 1970s with lending focused on commercial property. This resulted in a major financial crisis in the early 1970s. This was followed by the growth in bank lending to finance the acquisition of residential property as the banks took over an area of business previously dominated by the building society sector. Housing markets and credit have a special role in magnifying risk in financial system.¹¹ It is the growth in credit, particularly used to acquire residential property, coupled, in some instances, with the development of securitised assets that changed the banking landscape in recent decades in the UK. In the UK this has been a relatively recent issue. Historically, banks did not lend against the security of property.

In part this derives from the social perception of the purpose of banking. Unlike many other jurisdictions banking has been culturally acceptable as a “gentlemanly profession” in the UK for at least the last two hundred years.¹² The elevated status of banks was based on their role in facilitating markets in the prestigious areas of bill-broking and the financing governments and international trade and development. Banks avoided lending against the

¹⁰ Frederic Mishkin, ‘Prudential supervision, why is it important and what are the issues?’, in Frederic Mishkin (ed), *Prudential supervision*, (University of Chicago Press, Chicago, 2000), 27-26

¹¹ Markus Brunnermeier and Isabel Schnabel, ‘Bubbles and central banks: historical perspectives’, (2014), Gutenberg School of Management and Economics & Research Unit ‘Interdisciplinary Public Policy’ Discussion Paper 1411, 21-22, property bubbles are a constant feature throughout the period studied, (page 8). See also Raghuram Rajan, ‘Has financial development made the world riskier’, (2005) National Bureau of Economic Research Working Paper 11728; Claudio Borio and Haibin Zhu, ‘Capital regulation, risk-taking and monetary policy: a missing link in the transmission mechanism’, (2012) *Journal of Financial Stability* 8, 236-251; Gabriel Jiménez and Jesus Saurina, ‘Credit cycles, credit risk and prudential regulation’, (2006) *International Journal of Central Banking* 2, 65-98; Olivier Blanchard, Giovanni Dell’Ariccia and Paolo Mauro, ‘Rethinking macroeconomic policy’, (2010) *Journal of Monetary, Credit and Banking*, 42, 255-296

¹² William Rubinstein, *Capitalism culture and decline in Britain*, (Routledge, London, 1993), 39. See also P. J. Cain and Anthony Hopkins, ‘Gentlemanly capitalism and British expansion overseas (1688-1850)’, (1986) *The Economic History Review*, Vol. 39, No. 4, 501, 507-508

security of residential property. This latter area of business was left to the more déclassé small regional building societies. However, since legislative changes in the early 1970s, developments in prudential regulatory policy and the ending of the building society mortgage interest rate cartel in the early 1980s bank lending has concentrated on residential mortgages with, currently, two-thirds of bank balance sheets devoted to this type of lending.¹³ This has increased risk. In the event of default the security may be illusory for a variety of reasons, including the social obloquy that attaches to evicting borrowers. As a banker told me they are not in the business of casting families out into the street.

Moreover, mortgage lending produces very illiquid balance sheet assets. Concern over the value of these assets and their illiquidity has frequently resulted in those who provide finance to banks withdrawing their funds, resulting in a liquidity crisis and a subsequent solvency debacle. Thus it can be said that “mortgage credit growth has become a ...dominant driver of financial crisis risk, and mortgage credit overhang now weighs more on economic performance in recessions.”¹⁴ There is a strong argument that, in the UK, the deregulation of mortgage lending and the development of bank lending in this area in the 1980s was the foundation of macroeconomic instability.¹⁵ At its heart is a combination of factors including the growth in bank mortgage lending, the difficulties in pricing the assets and its inherent risks, the threat to trust that this engenders and the centrality of housing in producing both a wealth-multiplier effect and as a popular means of helping to provide for the future.

The next sections in this chapter develop a number of original concepts in the area of macroprudential policy. First, there is something analogous, in macroprudential policy, to

¹³ Òscar Jordà, Moritz Schularick and Alan Taylor, ‘The great mortgaging: housing finance, crises and business cycle’, (2014) Federal Reserve Bank of San Francisco, Working Paper Series 2014-23, 4; Alan Taylor, ‘Credit, financial stability and the macroeconomy’, (2015) National Bureau of Economic Research Working Paper 21039, 31 and Charles Goodhart, ‘Competition and Credit Control’, (2014) LSE Financial Markets Group, Special Paper 229, 12. See also Bank of England, ‘Competition and Credit Control’, (May 1971) and Bank of England, ‘The development of the building societies sector in the 1980s’, (1990) Bank of England Quarterly Bulletin, 503, 507

¹⁴ Ibid, (Jordà, Schularick and Taylor), 31-32

¹⁵ Peter Malpass, *Housing & the welfare state: the development of housing policy in Britain*, (Palgrave Macmillan, Basingstoke, 2005), 122

the idea of the “turbulent frontier” in geopolitics.¹⁶ Essentially, empires over-extend themselves by allowing their attention to focus on their frontiers - where there is always trouble. The next valley is occupied to suppress the disturbance which in turn becomes manifest in a second valley and so on. Similarly, regulation, in general, and macroprudential policy, in particular, is drawn towards new frontiers as risk is perceived to spread. This may well be the correct approach, but it requires a disciplined approach to policymaking which appreciates what is happening and determines priorities. Otherwise there is a risk that macroprudential policy may attempt to engage with too many areas and lose focus. Faced with a never-ending turbulent frontier the Emperor Diocletian created the Roman “Tetrachy” in order to increase imperial focus on what was important. By analogy, it may be necessary for the Financial Policy Committee, for example, to divide itself into two or more committees. Each would focus on different aspects of risks including those related to technology and infrastructure. This might appear cumbersome but this approach would ensure that sufficient attention was devoted to all the potentially important areas.

In addition, there are a number of structural issues with macroprudential policy including the relationship with microprudential regulation. It is possible that macroprudential and microprudential policies may work in opposite directions with potential conflicts between their respective objectives. Macroprudential policy may also fail to consider wider economic and societal issues. These factors may include limits on the ability of people to aspire to own their own home.

Further, too much may be expected of macroprudential policy since it may be too difficult to identify issues sufficiently early and both the capacity and will to intervene in time may be lacking. This is coupled with a belief that macroprudential policy can be “fine-tuned”.

Moreover, macroprudential tools appear to be jurisdiction specific since their effectiveness may depend on market and organisational structures. In addition, macroprudential policies may be linked to political structures and fiscal measures. In the UK macroprudential policies are largely untested and as a result of all these factors how, and whether, they work is still not clear. Nevertheless, there is merit in looking at other jurisdictions including the approach adopted in the US.

¹⁶ John S. Galbraith, ‘The “turbulent frontier” as a factor in British expansion’, (1960) *Comparative Studies in Society and History*, Vol. 2, No. 2, 150

In view of the limited previous use of macroprudential policy there is little knowledge and experience as to how they would work in practice. Consequently, there exists the potential for unintended consequences. For example, a limit on loan to income multiples may come to be seen as an acceptable target both by borrowers and lenders.

Finally, macroprudential policy may lack both political and institutional legitimacy. This concern is coupled with issues over accountability and may deter the use of macroprudential policies either at all or at the right time. Consequently, during a property boom the Bank of England's Financial Policy Committee (FPC) may not consider that it has sufficient "legitimacy" to impose significant loan to value (LTV) and loan to income (LTI) or debt to income (DTI) restrictions. This perception may also be shared by others in the political and media world.

The focus of academic legal writing on mortgage regulation has been on LTV and DTI macroprudential tools. There has been little on the role of the conduct of business aspects of mortgage lending beyond the limits of consumer protection. This aspect, including assessing the ability of borrowers to afford the mortgage, are rarely mentioned or heeded by the FPC. This thesis suggests that innovative use of the mortgage affordability assessment should form a major element of the quantitative measures available for macroprudential policy. If developed and applied appropriately this approach could protect both borrowers and the stability of the financial system. A central theme of this thesis is to rebalance the perception of macroprudential policy with what conduct of business regulation can achieve to support it.

In summary, macroprudential policy needs to be subject to realistic expectations with limited "role responsibility creep" and the policymakers need to establish the public and political legitimacy of their role. Macroprudential policy must be coordinated with monetary and fiscal policy and with those undertaking similar responsibilities in other jurisdictions. Finally, it should not neglect the importance of conduct of business regulation in restricting the growth of credit in the economy.

It is this latter point that is developed in later sections in relation to the UK housing market.

2.2 Housing markets and credit and their link to systemic risk

This section looks at what is meant by the term “systemic risk” in the financial system and the importance of credit growth and property prices both as a cause and as an indicator of risk to the equilibrium of the financial and economic system. It also considers the “wealth effect” generated by homeownership and that the importance of access to having a home of one’s own has a political complexion. However, it is the failure to note and address the build-up of systemic risk in the most recent financial crisis that threatened not just individual financial institutions but the financial system as a whole.

The analysis of the causes is important since the effectiveness of macroprudential policies depend on the weight given to each of the suggested reasons.¹⁷ Some blame the recent financial crisis on the development of a classic housing price “bubble” with rising house prices fueling the demand for credit.¹⁸ There are a range of explanations given for the rapid rise in house prices leading up to 2007. Goodhart considers that the way housing finance was undertaken “was at the centre of the crisis” in a range of countries including the US.¹⁹ Some have suggested that the large global trade imbalances were the underlying cause for this excess credit.²⁰ These resulted in both an increase in the supply of credit and low interest rates which, in turn, encouraged increased demand for both

¹⁷ Less explored are the organisational structural of both banks and regulators and cultural reasons for the crisis. They can be grouped into three broad but over-lapping areas: the desire of individuals and organisational departments to self-restrict their areas of responsibility to those aspects with which they feel comfortable; a short organisational “attention span” due to changes in personnel, re-assessed priorities, new initiatives etc; a reluctance to use all the powers available hoping that the problem will resolve itself, Timothy Malloy, ‘Regulation, compliance and the firm’, (2003), 76 Temple Law Review, 451. See also Thomas Cook, ‘Cognitive, behavioral and temporal effects of confronting a belief with costly action implications’, (1970) 33 Sociometry 358, 366, Christopher Stone, *Where the law ends: the social control of corporate behavior*, (Harper and Row, New York, 1975) and work demonstrating that “increased functional complexity” within an organisation leads to problematic individual behaviour, Joseph Dimento, *Environmental law and American business: dilemmas of compliance*, (Plenum Press, New York, 1986)

¹⁸ Ryan Bubb and Pasad Krishnamurthy, ‘Regulating against bubbles’, (2014) 163 University of Pennsylvania Law Review, 1553 and Edward Glaeser, Joshua Gottlieb and Joseph Gyourko, ‘Can cheap credit explain the housing boom?’, (2010), National Bureau of Economic Research, Working Paper 16230. See also Andrey Pavlov and Susan Wachter, ‘Subprime lending and real estate prices’, (Spring 2011) Real Estate Economics, Vol. 39, Issue 1, 1–17, 1-2, who see new style mortgages as magnifying the housing cycle

¹⁹ Charles Goodhart, ‘Property finance has been the main common factor’, (Written evidence to the Parliamentary Commission on Banking Standards, House of Commons, 24th October 2012)

²⁰ Ouarda Merrouche and Erlend Nier, ‘What caused the global financial crisis? —evidence on the drivers of financial imbalances 1999–2007’, (2010) IMF Working Paper, WP/10/265, 29. See also Christopher Mayer and Todd Sinai, ‘U.S. house price dynamics and behavioral Finance’ in Christopher Foote, Lorenz Goette and Stephan Meier (eds), *Policy making insights from behavioral economics*, (Federal Reserve Bank of Boston, Boston, 2009), 273

credit and housing. Others strongly believe that the increased prevalence of securitisation and financial innovation allowed lenders to increase their provision of home loans.²¹ Aspects of financial innovation in the US and the role of government sponsored enterprises are explored chapter 7. Finally, there is a view that government and its agencies interfered in the housing market and through legislation and financial operations created an unsustainable boom in credit availability and home buying.²²

In addition, economic modelling has failed to recognise the central role of banks, the growth of bank balance sheets, and coupled with asset prices increases, and the role of banks in the increasing level of debt in the economy.²³ This combined with periodic bursts of “euphoric expectations” and coupled with increased financial inter-connectedness have been at the heart of most financial crises.²⁴

While there are a number of definitions of macroprudential policy, it is clear that the broad objective is to protect the financial system as a whole from “systemic risk”. There are a number of views on what constitutes “systemic risk”.²⁵ These range from an unexpected changes in prices in credit and asset markets as result of disturbances in financial markets “which lead to a danger of failure of financial firms which in turn threatens to spread so as to disrupt” other financial systems.²⁶ This can arise from correlation of returns on the asset-side of bank balance sheets [since] banks prefer an inefficiently high correlation of

²¹ Adam Levitin, Andrey Pavlov and Susan Wachter, ‘Securitization: cause or remedy of the financial crisis’, (2009), Georgetown University Law Centre, Research Paper No. 1462895 and University of Pennsylvania Law School, Institute for Law and Economics, Research Paper No. 09-31

²² Atif Mian, Amir Sufi and Francisco Trebbi, ‘The political economy of the US mortgage default crisis’, (November 2008) National Bureau of Economic Research, Working Paper No. 14468

²³ Atif Mian, Kamalesh Rao and Amir Sufi, ‘Household balance sheets, consumption and the economic slump’, (2013) Quarterly Journal of Economics, 128, 4, 1687-1726, 1693 and 1724

²⁴ Hyman Minsky, *Can ‘it’ happen again? Essays on instability and finance*, (Routledge, London, 1982) 150-151

²⁵ Supra note 8, (Schwarcz, ‘Systemic risk’), 202. See also Jean-Claude Trichet, ‘Systemic risk’, The Clare Distinguished Lecture in Economics and Public Policy at the University of Cambridge, 10th December 2009, describing systemic risk as a “seizing-up of the financial system”. European Central Bank, ‘The concept of systemic risk’, (December 2009) Financial Stability Review 134, This adds “herd” behaviour and the moral hazard resulting from regulatory safety nets to the factors responsible for financial instability

²⁶ Philip Davis, *Debt, financial fragility and systemic risk*, (Clarendon Press, Oxford, 1992), 118, Amir Khandani, Andrew Lo and Robert Merton, ‘Systemic risk and the refinancing ratchet effect’, (2013) Journal of Financial Economics 108, 29-45. This considers the role of low interest rates and property values, as factors in creating financial instability. See also Anna Gelpen, ‘Financial crisis containment’, (2009) 41 Connecticut Law Review 1051- 1106, 1064-5 on circuit-breakers to contain instability

asset returns (“herd [effect]”), giving rise to systemic or aggregate risk.”²⁷ This can produce a period of high financial instability where risk can no-longer be priced. Financial instability can also be seen as the result, or cause, of a break down in trust. In the recent crisis, lenders would not lend to other financial institutions who in turn would not lend - in a version of the prisoners’ dilemma where cooperation was not possible.²⁸

The origins of the financial crises lay in the rapid build-up of credit and its relationship to property prices in the period preceding the collapse.²⁹ This form of systemic risk is not a recent phenomena. It was a major factor in the three most recent property crises in the UK (ie the secondary banking crisis in the early 1970s, the small banks crisis 1990-94 and the most recent financial crisis). In all these cases “it is clear that a rapid build-up of private credit was a lead indicator of the crisis to follow.”³⁰

An analysis of financial crises in five countries in the latter part of the 19th century and early 20th century found close links between the growth of credit and a rapid expansion in both equity and property markets.³¹ In all cases this resulted in a rise in bad debts, destroying many banks and threatened the financial infrastructure.³² There is an argument that the 1930s depression in the US had its roots in the residential property boom of the 1920s.³³ One review found that of twenty-three countries that had booms in both property

²⁷ Viral Acharya, ‘A theory of systemic risk and design of prudential bank regulation’, (2009) *Journal of Financial Stability*, Vol. 5, 224, 227

²⁸ Lucian Bebchuk and Itay Goldstein, ‘Self-fulfilling market freezes’, (2011) *Review of Financial Studies*, Vol. 24, No. 11, 3519, 3521

²⁹ Mathias Drehmann, Claudio Borio and Kostas Tsatsaronis, ‘Anchoring countercyclical capital buffers: the role of credit aggregates’, (2011) *Bank of International Settlement Working Paper* 355, 1

³⁰ Julia Giese and others, ‘The credit-to-GDP gap and complementary indicators for macroprudential policy: evidence from the UK’, (2014) *International Journal of Finance and Economics*, Vol. 19, Issue 1, 25, 26

³¹ Giovanni Favara and Jean Imbs, ‘Credit supply and the price of housing’, (2015) *American Economic Review*, 105(3), 958-992, 984

³² Charles Goodhart and P. Delargy, ‘Financial crises: plus ca change, plus c’est la meme chose’, (1999), Special Paper No. 108, London School of Economics Financial Markets Group, 261, 263. See also Barry Eichengreen and Michael Bordo, ‘Crises now and then: what lessons from the last era of financial globalization?’, (2002), National Bureau of Economic Research, Working Paper 8716, post-1990s crises parallels those in the late 19th and early 20th centuries with an over-investment in property coupled with weakly regulated banking systems

³³ Alexander Field, ‘The interwar housing cycle in the light of 2001-2012: a comparative historical perspective’ in Eugene White, Kenneth Snowden and Price Fishback (eds), *Housing and mortgage markets in historical perspective*, (National Bureau of Economic Research, University of Chicago Press, Chicago, 2014), 39-80

prices and credit before the crisis, twenty-one experienced either a financial crisis or a significant drop in GDP growth.³⁴ However, of the seven countries that experienced a boom solely in property prices only two had a systemic financial crisis.

Nevertheless, there is a distinction to be drawn between the consequences of major falls in equity prices compared with the periodic collapses of the housing market seen during the second half of the 20th Century. Crises involving major equity falls are more evenly spread while housing price crises are much more clustered and, in addition, approximately 40% of house price escalations were followed by property value collapses.³⁵ Housing price falls are not as deep (no more than 30% on average) but have a more wide-spread and longer lasting effect on the economy (due to a broader wealth effect) and much stronger and faster consequences for the banking system due to the additional provisioning costs, enhanced capital ratios and a reduced willingness to lend.³⁶ The “wealth effect” is stronger for house price growth compared with that for share price increases.³⁷ As a consequence housing crises are more difficult to unwind.³⁸ The house price decline following the recent financial crisis lasted at least six years.³⁹

The evidence suggests that the loan security provides the currency to support the growth in lending. Leveraging the value of this collateral has a multiplier effect on credit since increased credit availability increases demand for property and this in turn raises house

³⁴ Christopher Crowe and others, ‘Policies for macrofinancial stability: options to deal with real estate booms’, (2011a) IMF Staff Discussion Papers, SDN/11/02. See also Richard Herring and Susan Wachter, ‘Real estate booms and banking busts: an international perspective’, (1999), Wharton Financial Institutions Centre, University of Pennsylvania, Working Paper 99-27

³⁵ IMF study of asset price cycles, ‘When bubbles burst’, (2003), IMF World Economic and Financial Survey, Chapter II, 61, 63

³⁶ Ibid, IMF, 63 on the “wealth effect” which describes the relationship between asset prices and consumer spending. There appears to be a psychological link between an increase in the value of an individual’s shareholding or house price and their propensity to spend, Filippo Altissimo and others, ‘Wealth and asset price effects on economic activity’, (2005) European Central Bank Occasional Paper Series 29, 34 and John Campbell and João Cocco, ‘How do house prices affect consumption? Evidence from micro data’, (2005), National Bureau for Economic Research Working Paper 11534, 35

³⁷ Karl Case, John Quigley and Robert Shiller, ‘Comparing wealth effects: the stock market vs. the housing market’, (2005) *Advances in Macroeconomics*, Vol. 5 Issue 1, Article 1, 26

³⁸ Supra note 35, (IMF), 72-73, house prices declines lasted on average four years.

³⁹ Carmen Reinhart and Kenneth Rogoff, *This time is different*, (Princeton University Press, New Jersey, 2009), 226

prices.⁴⁰ The higher property values in turn provide great security for more loans and so on. If asset prices fall the multiplier effect is reversed. The result amplifies and spreads through the economy.⁴¹

There is also something special about economic recessions which follow a rapid expansion in credit coupled with a house price boom. It appears that these types of economic troughs are longer and deeper and affect many other parts of the economy and have a deleterious effect on the whole economy.⁴² Consequently, it is fair to say that housing markets are exceptional and are not like other markets in their economic effect. This is probably due to residential property forming the major part of personal wealth with the resulting large “amplification effect” mentioned earlier.⁴³ Moreover, there is a close inverse relationship between house price increases and the decline in savings correlated with increased consumer spending.⁴⁴

In addition, the value of a household’s equity in their home (the rising value of the property, less the outstanding mortgage) represents future aspirations since it provides an opportunity to buy a bigger home, possibly to accommodate a growing family or a move to somewhere new to find work or a better job.⁴⁵ In other words, the equity in a current home represents not only the deposit for the next but also hope for the future. This is an important but neglected perspective in many economic assessments. However, it is a major reason why access to homeownership is high on the political agenda in both the UK and US and in many other jurisdictions - and why this issue cannot be left solely to

⁴⁰ Òscar Jordà, Moritz Schularick and Alan Taylor, ‘Betting the house’, (December 2014) National Bureau of Economic Research, Working Paper 20771, 37

⁴¹ Nobuhiro Kiyotaki and John Moore, ‘Credit cycles’, (1997) *Journal of Political Economy*, Vol. 105, No. 2, 211, 212. “The system’s reaction to shocks is highly nonlinear. Once in a crisis regime, even small shocks are subject to amplification, leading to significant.... risk”, Markus Brunnermeier and Yuliy Sannikov, ‘A macroeconomic model with a financial sector’, (2014) *American Economic Review* 104, 379, 381-382

⁴² Stijn Claessens, Ayhan Kose and Marco Terrones, ‘What happens during recessions, crunches and busts’, (2008b) IMF Working Paper, WP/08/274, 34

⁴³ Jeremy Stein, ‘Prices and trading volume in the housing market: a model with down-payment effects’, (May 1995), *The Quarterly Journal of Economics*, Vol. 110, No. 2, 379, 380-383. In the US equity in the home as a percentage of household wealth has fallen from thirty percent in 2000 to twenty-five percent in 2011, Alfred Gottschalck, Marina Vornovytssky, and Adam Smith, ‘Household wealth in the US: 2000 to 2011’, US Census Bureau

⁴⁴ Dan Andrew, Aida Caldera Sánchez and Asa Johansson, ‘Housing markets and structural policies in OECD countries’, (2011) OECD Working Paper No. 836, 56

⁴⁵ Supra n43, (Stein), 383

technocratic judgements.⁴⁶ The involvement of politics in macroprudential policy and the latter's role in house price growth and access to credit is considered later in this and subsequent chapters.

2.3. The role of credit

As mentioned earlier, systemic financial instability is frequently caused by a combination of a rapid increase in credit and residential property price inflation. The empirical evidence indicates that the credit system itself acts a “potential source of financial instability and not merely as an amplifier of shocks.”⁴⁷ The quality of bank credit assessment processes commonly appear to deteriorate during a property asset price boom in part due to the agency effect of mortgage intermediaries and the difficulty in establishing “true” asset prices in a booming market.⁴⁸ These issues were explored before the start of the recent financial crisis and the conclusion was that “excessive credit created ‘imbalances’ and a risk of financial instability.”⁴⁹

The view that “financial crises are credit booms gone wrong” has been known since at least the 1970s and proponents of this perspective have recently been “rediscovered” following the 2007/8 financial crisis.⁵⁰ In Minsky's analysis money acts as a “veil of finance”

⁴⁶ Stijn Ferrari, Mara Pirovano and Wanda Cornacchia, ‘Identifying early warning indicators for real estate-related banking crises’, (2015) ESRB Occasional Paper No. 8, 5 for an example of the wholly technocratic approach

⁴⁷ Moritz Schularick and Alan Taylor, ‘Credit booms gone bust: monetary policy, leverage cycles and financial crises, 1870–2008’, (2012), *American Economic Review*, Vol. 102, No. 2, 1029 - 1061, 1042

⁴⁸ Franklin Allen and Elena Carletti, ‘Systemic risk from real estate and macroprudential regulation’, (2013), *International Journal of Banking, Accounting and Finance*, Vol. 5, Nos. 1-2, 28

⁴⁹ Claudio Borio and Philip Lowe, ‘Asset prices, financial and monetary stability: exploring the nexus’, (2002) BIS Working Papers, No 114, 27. In this paper the authors presciently state that “financial imbalances can build-up in low inflation environments and that in some cases it is appropriate for policy to respond to these imbalances... Against this background, there is a risk of greater amplitude in financial cycles going hand in hand with more disruptive booms and busts in real economic activity.” See also William White, ‘Is price stability enough?’, (2006), BIS Working Papers No. 205, 15-16. Claudio Borio and William White, ‘Whither monetary and financial stability? The implications of evolving policy regimes’, (2004) BIS Working Papers No. 147, 26; Charles Goodhart, ‘Whatever became of the monetary aggregates?’ Peston Lecture in honour of Maurice, Lord Peston, delivered at Queen Mary College, London, 28th February 2007, 13, (On the cusp of the financial crisis Charles Goodhart looked at the transmission effect on the economy of credit growth)

⁵⁰ Henry Kaufman, ‘Debt: the threat to economic and financial stability’, (1986), *Economic Review*, Federal Reserve Bank of Kansas, Vol. 71, No. 10, 3, 6, (“The build-up of debt in the economy is due to a variety of factors including financial deregulation and innovation, the development of securitisation and financial internationalisation and tax structures and a lack of “debt prudence”)

between a real asset (eg a building), the borrower and the lender with banks acting as the intermediary with the creation of debt obligations. The result is uncertainty and potential instability.⁵¹ Subsequent work indicates a strong correlation between monetary policy, rising household debt and house prices coupled with lax underwriting and mis-priced risk.⁵² There is also a correlation between an increase in household debt and a subsequent fall in GDP growth.⁵³

It is the interaction between asset prices, particularly in the housing sector, and credit that makes the need for macroprudential policy necessary to control credit growth. However, first it is important to consider the conceptual basis for macroprudential policy.

2.4 The definition of macroprudential policy

Macroprudential policy is a new and inchoate area.⁵⁴ This section seeks to explain what it includes and its relationship with the more traditional microprudential form of regulation.

EU Regulation has defined macroprudential policy as the “oversight of the financial system ... in order to contribute to the prevention or mitigation of systemic risks to financial stabilitythat arise from developments within the financial system and taking into account

⁵¹ Hyman Minsky, ‘The financial instability hypothesis: an interpretation of Keynes and an alternative to ‘standard theory’’, (1977), Hyman P. Minsky Archive, Paper 38, 4-6. See Charles Whalen, ‘Rethinking economics for a new era of financial regulation: the political economy of Hyman Minsky’, (2011) 15 Chapman Law Review 149 and Randall Wray, *Why Minsky matters: an introduction to the work of a maverick economist*, (Princeton University Press, New Jersey, 2015)

⁵² Matt Waldron and Fabrizio Zampolli, ‘Household debt, house prices and consumption in the United Kingdom: a quantitative theoretical analysis’, (2010) Bank of England Working Paper No. 379, 3-4. See the letter from the Chancellor of the Exchequer to the Governor of the Bank of England setting out the objective of the Bank’s Monetary Policy Committee, dated 16th March 2016.

⁵³ Atif Mian, Amir Sufi and Emil Verner, ‘Household debt and global growth’, (2015) National Bureau of Economic Research Working Paper No. 21581, 22

⁵⁴ Bank of England, ‘The role of macroprudential policy: a discussion paper’, (November 2009), setting the ground work for the establishment of the Financial Policy Committee. See also a BIS paper: ‘Central bank governance and financial stability’, (May 2011), which sets out the options for establishing macroprudential authorities and supra note 9, (IMF’s ‘Key aspects’). Luis Jácome and Erlend Nier, ‘Macroprudential policy: protecting the whole’, (March 2012) IMF. See also ‘Is the active use of macroprudential tools institutionally realistic?’, panel remarks by William Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the ‘Macroprudential monetary policy’, 59th Economic Conference of the Federal Reserve Bank of Boston, Boston, Massachusetts, 3rd October 2015; G20, ‘Seoul summit document: framework for strong, sustainable and balanced growth’, (November 2010) paragraph 41

macroeconomic developments, so as to avoid periods of widespread financial distress.”⁵⁵
In this context the financial system includes “all financial institutions, markets, products and market infrastructures”.⁵⁶

However, UK legislation has avoided defining macroprudential policy. It instead provides the Bank of England with broad objectives, organisational and governance mechanisms and specific macroprudential tools (eg The Bank of England Act 1998 (Macroprudential Measures) Order 2013).⁵⁷

Macroprudential policy can be analysed into four main aspects: the monitoring and identification of risks to financial stability; the prevention of these risks; the containment and control of these risks in order to reduce their occurrence and to limit their effect and, finally, if severe financial instability occurs to prevent, or reduce, its transmission to areas of the economy beyond the financial services system (ie the so-called “real economy”).⁵⁸ Macroprudential policy includes financial markets as well as institutions. Additionally, it encompasses the financial systems’ infrastructure including the payments systems and the arrangements which ensure trust and the integrity of, and across, global markets. These include, for example, credit rating agencies and external auditors. Moreover, macroprudential policy needs to look across borders, and over the longer term, in order to ascertain what risks to financial stability may be building up with implications for financial stability.

Macroprudential policymakers also need to be aware of any severe operational issues including those not directly related to financial services. For example, a significant breakdown in the farm payments and support system may have wide-spread effects on the

⁵⁵ EU Regulation No. 1092/2010 of 24th November 2010 on European Union macroprudential oversight of the financial system and establishing a European Systemic Risk Board, Article 3

⁵⁶ Ibid, (EU 1092/2010), Article 2

⁵⁷ House of Lords’ European Union Committee, ‘The future of EU financial regulation and supervision’, (2009)

⁵⁸ There are a number of views on how systemic risk is transmitted. Augustin Landier, David Sraer and David Thesmar, ‘Banks’ exposure to interest rate risk and the transmission of monetary policy’, (2013) NBER Working Paper 18857; Mateo Ciccarelli, Angela Maddaloni and José-Luis Peydró, ‘Heterogeneous transmission mechanism: monetary policy and financial fragility in the euro area’, (2013) Economic Policy 28 (75), 459-512; supra note 11, (Borio and Zhu), 8. Systemic risk also affects bi-lateral contracts. From my own experience it always manifests itself in a dash for liquidity with assets being hurriedly sold and payment demanded earlier than expected. Its common factors is distrust both of the value of assets and other counter-parties. All trading stops no-one is trusted since no-one knows what is true or false. Kindleberger described these symptoms of panic in financial markets (Charles Kindleberger, *Manias, panics and crashes*, (Macmillan Press, London, 1987), 113-115

ability of farmers to meet their debt obligations. Finally, macroprudential policy must not shy-away from areas with a political dimension. For example, in the context of this thesis, the failure to build anything approaching the necessary number of new homes each year in the UK increases both house prices and the demand for more credit. The result may be greater risks to financial stability from an expanded growth in credit and inflated asset prices. Part of the concern expressed in this thesis is that those that operate macroprudential policy may not comprehend its full scope and the need for the Bank of England's macroprudential mandate to extend to a range of areas which traditionally have been outside the Bank's scope. This is likely to be seen as encroaching on public policy, such as house building, with implications for the political legitimacy of the Bank of England. These aspects are developed in chapters 6 and 8.

Moreover, transnational macroprudential policy may be even more complex since, for example, the European Central Bank has no responsibility for areas of financial services outside banking.⁵⁹ Similarly, the membership of the European Systemic Risk Board's governing board consists primarily of central bankers since it is perceived that "if you put together central banks in such a body you are going to have the right people in the right place because it is going to force these central banks to be more active on the essential thing, which is detecting systemic risks...".⁶⁰ Bringing central bankers together may assist in identifying risks to financial stability, many of which may have cross-border implications, at the same time it may limit the necessary broader perspective. Although the governing board includes representation from the European authorities responsible for other financial areas, such as insurance and asset management, its focus on central banks is likely to be a significant weakness. Part of the reason for this apparent narrow focus may lie in the history of macroprudential policy. The next section considers how macroprudential policy has developed in recent years.

2.5 The development of macroprudential policy

The risks of bank maturity transformation to financial stability have long been known. It is claimed that it was while considering this subject that the term "macroprudential" was first

⁵⁹ See the oral evidence given by Jacques De Larosière to the House of Lords European Union Committee for its 14th Report of Session 2008–09, 'The future of EU financial regulation and supervision', 149

⁶⁰ Ibid, 150

used when it was recorded “in the minutes of a meeting 1979 of the Basel Committee on Banking Regulation and Supervisory Practices discussing the potential collection of data on maturity transformation in international bank lending.”⁶¹ This was developed further by Andrew Crockett, the General Manager of the Bank of International Settlements, in a speech in October 2000, considering both microprudential and macroprudential policy and the need to develop the latter system of financial supervision of banks.⁶² This highlighted the risk to the whole economy as a result of individual, rational actions by financial institutions, which collectively threaten the system as a whole. This narrow approach is mirrored by microprudential regulation and supervision which seek to limit the risk of failure of individual financial institutions. The latter “approach was seen as treating aggregate risk as independent of the collective behaviour of institutions Crucially, this excluded the possibility that actions could appear individually rational but, in the aggregate, result in undesirable outcomes, owing to the externalities involved.”⁶³

Crockett explained that the only difference between these two forms of regulation is in their objectives and “the conception of the mechanisms influencing economic outcomes. It has less to do with the instruments used in the pursuit of those objectives.”⁶⁴ The differences between microprudential and macroprudential policy can be best illustrated by considering the perspective of the microprudential supervisor instructing a bank to improve its capital position. “The regulator does not care whether the bank adjusts [its capital ratio] via the numerator or via the denominator—that is, by raising new capital or by shrinking assets.”⁶⁵ This is an example of the “fallacy of composition” where what is a rational action for individuals in a group has an adverse consequences for the group, and hence individuals,

⁶¹ Piet Clement, ‘The term ‘macroprudential’: origins and evolution’, (2010) BIS Quarterly Review, March, 59. See also Stefan Ingves, ‘The evolution of the Basel Committee’, keynote address at a symposium to mark 25 years of the Basel Capital Accord, Basel, 26th September 2013. For a review of the discussions on macroprudential policy within BIS in 1979/1980 see Ivo Maes, ‘On the origins of the BIS macroprudential approach to financial stability: Alexandre Lamfalussy and financial fragility’, (October 2009) National Bank of Belgium, Working Paper Research No. 176, 9-16

⁶² Ibid, (Clement), 63

⁶³ Ibid, (Clement), 64

⁶⁴ Andrew Crockett, ‘Marrying the micro- and macroprudential dimensions of financial stability’, (BIS speech on 21st September 2000), 2. See also Paolo Angelini, Sergio Nicoletti-Altimari and Ignazio Visco, ‘Macroprudential, microprudential and monetary policies: conflicts, complementarities and trade-offs’, (2012) Bank of Italy Occasional Paper 140, 27

⁶⁵ Samuel Hanson, Anil Kashyap and Jeremy Stein, ‘A macroprudential approach to financial regulation’, (2011) Journal of Economic Perspectives Vol. 25, No.1, 5

as a whole.⁶⁶ The similarities between microprudential and macroprudential supervisory tools are considered later in this chapter.

Additionally, there is a view that financial stability can be enhanced by improving the ability of financial firms to enter and exit the market with the least disruption via workable recovery and resolution plans and that this will require less focus on the traditional methods of microprudential regulation.⁶⁷ The development of macroprudential policy may also complicate the role of the Bank of England which has to operate both a monetary policy regime alongside macroprudential and microprudential policies.⁶⁸ The clear interaction between macroeconomic policy and macroprudential policy is considered in the next chapter.

As mentioned macroprudential policy objectives include “strengthening the resilience of the financial system” to economic downturns and other shocks and by “leaning against the financial cycle reducing the probability or magnitude of a financial crisis.”⁶⁹ It is anticipatory: it seeks to prevent a serious systemic problem developing.⁷⁰ Its effects are as much psychological as operational since it “acts on the expectations of financial institutions.”⁷¹

Moreover, the macroprudential policymaker may seek to control the rapid growth of credit or to limit the increase in the price of the asset being financed or to do both. This may be at odds with the aims of both investors in the bank and the microprudential supervisor. The latter two groups have an aligned interest in increasing the profits of the bank. The

⁶⁶ Ricardo Caballero considered this issue in his paper, ‘A fallacy of composition’, (1991), National Bureau of Economic Research Working Paper 3735

⁶⁷ Geoffrey Wood and Ali Kabiri, ‘Firm stability and system stability: the regulatory delusion’, in John Raymond LaBrosse, Rodrigo Olivares-Caminal and Dalvinder Singh (eds), *Managing risk in the financial system*, (Edward Elgar, Cheltenham, 2011), 181-193

⁶⁸ Charles Goodhart and Rosa Lastra, ‘Interaction between monetary policy and bank regulation’, (Report to the European Parliament, 21st September 2015), 7-11

⁶⁹ Bank for International Settlements, Committee on the Global Financial System, ‘Macroprudential instruments and frameworks: a stocktaking of issues and experiences’, (2010) CGFS Papers No. 38, 2

⁷⁰ Jean-Pierre Landau, (Deputy Governor of the Banque de France), ‘Bubbles and macro prudential supervision’, speech, at the conference on ‘The future of financial regulation’, Banque de France and Toulouse School of Economics, Paris, 28th January 2009, 1

⁷¹ David Aikman, Andrew Haldane and Benjamin Nelson, ‘Curbing the credit cycle’, (November 2010), Columbia University Center on Capitalism and Society Annual Conference, ‘Microfoundations for modern macroeconomics’, New York

microprudential supervisor is keen to increase retained earnings which strengthen the bank's capital and, at the same time, make it easier to attract new investors who supply new capital. Moreover, constraining the growth of credit has its disadvantages since setting "limits to credit expansion" may have "a consequential effect on the economy."⁷² This approach, discussed in more detail later, is itself controversial since the central banking view, prior to the financial crisis, was not to target asset price rises, since it was impossible to determine whether these were due to systemic imbalances or changes in economic fundamentals.⁷³ However, the evidence from the recent crisis is that a policy of passivity in the face of an asset price bubble is expensive in view of the cost of "cleaning up the mess".⁷⁴ However, it is difficult to identify a bubble and to act with the necessary speed. This is "coupled with the difficulty of gently deflating these bubbles" providing "serious impediments to such proactive approaches".⁷⁵ These issues raise questions over whether macroprudential policy can provide a "backstop for systemic risk containment".⁷⁶ This approach is developed further in the next chapter.

Nevertheless, again as mentioned earlier, there may be something special about rapid growth in property prices and the interaction with an accelerated growth in bank credit which necessitates a highly proactive approach.⁷⁷ Options for macroprudential policy

⁷² Supra, note 70, (Landau), 3

⁷³ Ben Bernanke and Mark Gertler, 'Monetary policy and asset price volatility', (2000), National Bureau of Economic Research Working Paper 7559, 6-9. See also "the key policy question is: If low-cost, incremental policy tightening appears incapable of deflating bubbles, do other options exist that can at least effectively limit the size of bubbles without doing substantial damage in the process? To date, we have not been able to identify such policies, though perhaps we or others may do so in the future.", Alan Greenspan, 'Economic volatility', speech at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 30th August 2002. See also Fredrick Mishkin, "How should we respond to asset price bubbles?" (October 2008) Banque de France, Financial Stability Review, No. 12, 65 - 74, 67-68 supporting the Bernanke/Gertler view

⁷⁴ Supra note 11, (Brunnermeier and Schnabel), 21-22

⁷⁵ Supra note 11, (Brunnermeier and Schnabel), 22-22

⁷⁶ Rosa Lastra, 'Systemic risk and macroprudential supervision' in Niamh Moloney, Eilís Ferran and Jennifer Payne (eds), *The Oxford handbook of financial regulation*, (Oxford University Press, Oxford, 2015), 317

⁷⁷ Stefan Gerlach, 'Housing markets and financial stability', speech at the National University of Ireland, Galway, 20th April 2012), pages 1-6 and Michael Bordo and Jeanne Olivier, 'Monetary policy and asset prices: does 'benign neglect' make sense', (2002) IMF Working Paper, WP/02/225, 24-25, 11, found that financial crises are triggered when house prices have peaked. In an analysis of fifteen advanced economies during the period 1970-2002 they identified twenty distinct housing booms, of these eleven were followed by an economic collapse and of these eleven, six involved banking crises. There is some correlation between the size of the property market in relation to the whole economy and the effect of the housing boom on the economy. highlighting this relationship between high property prices and the growth of credit

limiting asset price growth are considered in the next section. It is a central theme of this thesis that since the more traditional macroprudential tools for limiting credit growth may not be effective other options need to be considered.

2.6 The role of banks in asset price growth and the employment of macroprudential policy to control this

Macroprudential policy is needed both for financial markets and businesses since they demonstrate an aspect of the economic concept known as the “tragedy of the commons.”⁷⁸ There is no single “owner” of the financial system and consequently, in the lead-up to the financial crisis, banks and other financial institutions developed products and operated in such a way as to threaten the stability of the system as a whole. Financial stability meets the definition of a “public good” in that there is no rivalry and no exclusivity in that financial stability is indivisible, in that its benefits are available to all “its enjoyment by one jurisdiction does not reduce the amount available to another country.”⁷⁹ In economic terms the benefits accrued to the financial institutions but the risks were not internalised and, in many instances, fall on the state and taxpayers.

This risk to the stability of the system is magnified by the ability of banks to create money.⁸⁰ Left to their own devices banks will create money using short-term debt instruments. Consequently, it is important that “central banks should not be reluctant to deploy [their various] tools...in an effort to contain excessive private money creation,”⁸¹ It is

⁷⁸ First articulated in 1833 by William Foster Lloyd, ‘Checks to population’, (reprinted in 1980) Population and Development Review, Vol. 6, No. 3, 473, 483, using the example of overgrazed common land where while there is a collective, as opposed to an individual, interest in its conservation nothing is done

⁷⁹ Supra note 76, (Lastra, ‘Systemic risk’), 313. See also Joel Trachtman, ‘The international law of financial crisis: spillovers, subsidiarity, fragmentation and cooperation’, (2010) 13 (3) Journal of International Economic Law, 719-742, on the failures of regulatory “fragmentation” in the context of global risks, (pages 723-725)

⁸⁰ For example, the development of the discounted bill of exchange as a form of money created by banks turned business and commercial promissory notes into negotiable instruments. These documents, once endorsed by a bank of high standing, could be used, in turn, as security for more credit. The use of these short-dated financial instrument by one of the largest and most reputable UK bank of its time, to finance long-term infrastructure projects resulted in the last major bank run prior to Northern Rock when the bank failed in 1866, Geoffrey Elliott, *The Mystery of Overend and Gurney*, (Meuthen, London, 2006)

⁸¹ Jeremy Stein, ‘Monetary policy as financial stability regulation’, (2012), The Quarterly Journal of Economics, 127, 57, 91

the special function of banks to create money as they carry out the process of “maturity transformation”.⁸² The transformation of maturity can be reversed as long-term assets held by banks are then, in turn, changed, via securitisation, into shorter-term commercial paper liabilities which can be sold to another financial institution and then used as part of another maturity transformation process and so on. In parallel, banks will transform risk; both by increasing and decreasing risk. The extent and the speed of this process are at the heart of concerns with the stability of the financial system.

This section next considers the role of central bank in relation to asset price rises and their control. There has been a conceptual change of policy in this area among many central banks since the financial crisis but no clear determination who, if anyone, should carry out this task. This section examines how the financial system is threatened by the “tragedy of the commons”. While macroprudential policy sets a series of objectives it is in practice, defined by the “tools” employed and these, in turn, are conditioned by a range of factors including the institutional structures and political environment.

As mentioned earlier, part of the rationale for macroprudential policy is the need to limit rapid asset price growth. However, the view of central banks prior to the financial crisis was not to target asset price rises since it was impossible to determine whether these were due to systemic imbalances or changes in economic fundamentals.⁸³ More recently, this view was reiterated by the Governor of the Banque de France who said that asset prices should not be targeted by central banks. The latter should be limited to two broad

⁸² “At the heart of banking is ... maturity transformation, or more simply, banks borrow at a shorter term and lend at a longer term in respect of the duration of their deposits and loans. This is the essence of banking....This is a benefit to the economy and society because it allows longer-term borrowing by companies and by all of us to buy houses. But it makes banks inherently illiquid.” ‘Financial Stability – objective and resolution’, speech by Andrew Bailey at the Pro Manchester Business and Professional Services Conference, Manchester, 17th March 2011. See also Philip Lowe, Deputy Governor of the Reserve Bank of Australia on ‘The transformation in maturity transformation’ at the Thomson Reuters’ Third Australian Regulatory Summit, Sydney, 27th May 2015

⁸³ Supra note 73, (Bernanke and Gertler), and Bernanke and Gertler, ‘Should central banks respond to movements in asset prices?’, (2001) *The American Economic Review*, Vol. 91, No. 2, 253. However, Stefan Gerlach considers that there is something special about accelerations in the growth of the price of property, supra note 77. This is supported by research by Bordo and Olivier, supra note 77. However, it is difficult to identify a housing bubble early enough, or at all. Charles Bean, ‘Asset prices, financial imbalances and monetary policy: are inflation targets enough?’, speech at BIS, 29th March 2003. He also mentioned that achieving “price stability may be associated with heightened risks of financial instability.” See also John Taylor, ‘The financial crisis and the policy response: an empirical analysis of what went wrong’, (2008), *A Festschrift in Honour of David Dodge’s Contributions to Canadian Public Policy*. Ottawa: Bank of Canada, 1. However, this is disputed by Ben Bernanke, ‘Monetary policy and the housing bubble’, speech at the annual meeting of the American Economic Association in Atlanta, 3rd January 2010

objectives: “price and financial stability”.⁸⁴ The governor was critical of some who have “suggested including asset prices in the index targeted by the central bank.” He saw this “as a distinctly sub-optimal solution, as it would essentially amount, in practice, to moving to a situation with one instrument, monetary policy, aiming at a combination of two objectives, price and financial stability.”⁸⁵ This can be contrasted with the views of Padoa-Schioppa who considered that monetary policy, working in tandem with microprudential supervision and backed by the availability of emergency liquidity, would be sufficient to ensure financial stability.⁸⁶ He saw “banking as a system” in which the “pursuit of financial stability occupies a ‘land in between’ monetary policy and prudential supervision”.⁸⁷ As mentioned earlier, the relationship between monetary policy and macroprudential policy is considered in the next chapter.

As mentioned, it is clear that macroprudential policy is, at best, a set of broad objectives. It is the variety and use of a range of macroprudential “tools” which defines this form of regulation. In contrast, microprudential regulation is based on promulgating rules, both substantive and procedural, for regulated firms coupled with effective supervision of how firms comply with these requirements. The next chapter considers a subset of the full macroprudential “tool-kit”, their effectiveness and the limitations on their use. However, this thesis advocates both the use of conduct of business rules as part of the set of macroprudential tools as well as limiting asset price growth by substantially increasing the supply of housing.

Before considering this it is necessary to look at the structure of the financial system and what is meant by “financial instability” and to consider whether macroprudential policy can reduce the risk of this developing in way which is difficult to control.

⁸⁴ Christian Noyer, ‘Monetary policy and macroprudential policy’ speech at a conference on ‘The future of monetary policy’, Banca d’Italia, Rome, 30th September 2010

⁸⁵ Ibid, (Noyer)

⁸⁶ Tommaso Padoa-Schioppa, ‘Central banks and financial stability’, speech in Jakarta, 7th July 2003. See also Tommaso Padoa-Schioppa, ‘Central banks and financial stability: exploring the land in between’ in V. Gaspar, P. Hartmann and O. Sleijpen (eds), *The transmission of the European financial system*, (European Central Bank, Frankfurt, 2003)

⁸⁷ Tommaso Padoa-Schioppa, *Regulating finance: balancing freedom and risk*, (Oxford University Press, Oxford, 2004), 94 and 97

2.7 The structure of financial systems

There are a number of ways of looking at financial systems. Understanding these different perspectives, as mentioned earlier, is important as the need to understand the various structures may determine macroprudential policy. Under any form of analysis financial systems are complex and subject to unpredictable shocks which transmit their effect with “non-linearity” (ie the effects and causes are difficult to model and predict).⁸⁸ Haldane described the financial system as being on a constant “knife-edge” where, for reasons that are difficult to model and hence forecast, “even a modest piece of news might be sufficient to take the system beyond its tipping point.”⁸⁹

A financial system is connected via a myriad of agents, each with only a limited perspective on the whole system, and subject to “bounded rationality”.⁹⁰ Many of the linkages in the system arise from a number of common factors such as shared depositor bases and mutual interactions in the interbank market.⁹¹ Aspects of these issues are discussed in the next section.

This complexity has been identified by recent analysis which instead has concentrated on a small number of individual financial institutions and their direct effect on systemic risk.⁹² This highlights both the role of these firms in their exposure to systemic risk and in the transmission of instability. This latter aspect is considered later in this chapter. However,

⁸⁸ Supra note 69, (CGFS), 19. Attempts have been made since the 1980s to model complex financial economic systems with many “agents” (ie central banks, legal systems etc). George Box, ‘Science and statistics’, (December 1976) *Journal of the American Statistical Association*, Vol. 71, No. 356, 791-799, 792 concluded that all theoretical models are wrong but some may still be useful as “approximations of the real world.” See also Blake LeBaron and Leigh Tesfatsion, ‘Modeling macroeconomies as open-ended dynamic systems of interacting agents’, (2008) *The American Economic Review Papers and Proceedings*, 98(2), 246

⁸⁹ Andrew Haldane, ‘Rethinking the financial network’, speech at the Financial Student Association, Amsterdam, 28th April 2009

⁹⁰ See Chapter 5 for a brief analysis of the concept of “bounded rationality”

⁹¹ Committee on Economic and Monetary Affairs hearing, 15th February 2016, 3

⁹² Nikola Tarashev, Claudio Borio and Kostas Tsatsaronis, ‘Attributing systemic risk to individual institutions’, (2010) BIS Working Papers No 308, 21. See also Xin Huang, Hao Zhou and Haibin Zhu, ‘Assessing the systemic risk of a heterogeneous portfolio of banks during the recent financial crisis’, (2009), Federal Reserve Systems Finance and Economics Discussion Series. The collapse of the Crown Agents is an example of the importance one organisation may have in the development of a bubble and subsequent financial collapse. It would have been difficult to predict its significant influence in advance of the crisis in the early 1970s. The Crown Agents was a government agency which made significant loans to “secondary banks” in the prelude to the UK’s financial crisis in the early 1970s, *Report by the committee of inquiry into the circumstances which led to the Crown Agents requesting financial assistance from the Government in 1974*, (HMSO, London, December 1977), 32 and 69

the complexity of the financial system means that any attempt to gain a view of the whole and to control it are likely to fail. However, it may be possible to concentrate regulatory efforts on a few more precise areas. This is best approached by understanding what is meant by “financial instability”. This is considered in the next section.

2.8 What is understood by the term “financial instability”

This section looks at why financial instability is important and at its various forms and then considers how financial instability is transmitted through the financial system. The phrase “financial stability” is not an abstract term, since it relates to the individual actions of, and the consequences on, firms operating in the financial sector. It also has a deep resonance within the wider economy and affecting both political actors and internationally, with countries connected by trade and investment. Importantly, it is closely tied to the general population who rely on the financial system and who are contributors to its existence. Consequently, systemic risk has been defined as “the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components”.⁹³

There are a number of ways of looking at financial stability. However, all assume a large element of economy equilibrium and consider what could distort this balance. This approach is important since how these distortions are perceived can determine how and when the macroprudential policy should be imposed and which “tools” are best in the circumstances. This form of analysis is also central to how distortions to the equilibrium are measured, since if the disturbance cannot be detected, any macroprudential regulatory action may be too late.

There are three broad types of threat to financial stability.⁹⁴ The first category of threat could arise from an irrational fear, based on a rational analysis (“all customers want to be at the head of the queue to get their money out at the same time”), or a concern founded on some change in an institution’s “fundamental” financial strength (eg a significant fall in the value of assets held by a bank and thus a consequent threat to the bank’s solvency).

⁹³ Rosa Lastra, ‘Systemic risk, SIFIs and financial stability’, (2011) *Capital Markets Law Journal* 6 (2), 197-213, 199

⁹⁴ Claudio Borio and Mathias Drehmann, ‘Towards an operational framework for financial stability: “fuzzy” measurement and its consequences’, (June 2009) BIS Working Papers No. 284, 5-8

The risk of contagion then spreads to such an extent that it threatens the financial system as a whole.⁹⁵

The second type of threat could arise from “either a shock from within the financial system or from one which is exogenous” which affects something which is common across some or all the financial system. It could relate to a tangible problem such as a breakdown in the payments system or, more conceptually, by a failure in trust across the financial system. The crisis, in the latter situation is brought about by “the inability to distinguish solvent from insolvent institutions”.⁹⁶ Rather than financial “contagion” spreading as a series of collapsing dominos my experience is that of markets seizing at more or less the same time as banks and other financial institutions seek to ascertain their own financial positions and to conserve liquidity and reduce external liabilities coupled with a simultaneous lack of trust in the financial position of other institutions.⁹⁷

There is a third type of thread analysed by Minsky and, subsequently, developed by Kindleberger, describing the “endogenous cycle view of financial instability”. Here the financial system is seen as inherently unstable with a “propensity [for] disaster”.⁹⁸ There is some “displacement” event which starts the process of accelerated credit provision and increased money supply coupled with a rapid growth in asset prices leading to a “bubble” and eventual collapse.⁹⁹ It is very difficult, ex-ante, to identify the “displacement event”. It could be an element of financial deregulation, some form of innovation, or significant new

⁹⁵ Douglas Diamond and Philip Dybvig, ‘Bank Runs, Deposit Insurance, and Liquidity’, (1983) *The Journal of Political Economy*, Vol. 91, No. 3, 401, 402. See also Gary Gorton, ‘Banking panics and the business cycle’, (1988) *Oxford Economic Papers* 40, 751, 778. The problem can be seen as one of “signal-extraction ...in which agents [ie customers and counter-parties] reasonably infer poor prospects for a bank from the withdrawal decisions of other[s]”, V. Chari and Ravi Jagannathan, ‘Banking panics, information, and rational expectations equilibrium’, (1988) *Journal of Finance* Vol.43 No.3, 749, 759

⁹⁶ Franklin Allen and Douglas Gale, ‘Financial contagion’, (2000) *The Journal of Political Economy* Vol. 108, issue 1, 3 or the “shock” could be to the payments system which freezes due uncertainty over the solvency of a counter-party, see Xavier Freixas, Bruno Parigi and Jean-Charles Rochet, ‘Systemic risk, interbank relations and liquidity provision by the central bank’, (2000) *Journal of Money, Credit and Banking* Vol. 32, No. 3, Part 2, 611, 613

⁹⁷ Markus Brunnermeier and others, ‘The fundamental principles of financial regulation’, *Geneva Reports on the World Economy*, (International Center for Monetary and Banking Studies and Centre for Economic Policy Research, 2009),13. The domino model and its deficiencies are also discussed by Tobias Adrian and Hyun Song Shin, ‘Liquidity and financial contagion’, (11th February 2008) *Banque de France, Financial Stability Review: Special issue on liquidity*, No. 11, 2-3

⁹⁸ *Supra* note 58, (Kindleberger), 15

⁹⁹ *Supra* note 58, (Kindleberger), 16-19

trading patterns (eg the emergence of China as part of the international economic system or the collapse of the Soviet Union).

It is clear from the recent financial crisis that “institutional and market systemic risks are inter-related and that a failure of even a small bank can have severe market implications.¹⁰⁰ Instability can develop rapidly, via interconnected financial markets and extend beyond the banking sector.¹⁰¹ The issue of transmission of financial instability is considered in the next section.

2.9 The transmission of financial instability

In any financial system there exist a number of flaws and highly interconnected systems appear to magnify these and facilitate their transmission.¹⁰² This magnification is increased by the propensity of financial firms to “herd” and to move in the same direction together.¹⁰³ The recent financial crisis highlighted how instability may be transmitted across global economic systems. The mechanisms include common exposure to the same categories of distressed assets, direct exposure to failing institutions, over-reliance on financial infrastructure provided by firms in difficulties and the effect on markets of forced asset sales amplified by “marked-to-market” accounting.¹⁰⁴ Beyond these concrete examples are the less perceptible but still highly influential issues relating to failures in trust in both between institutions and across markets. It is the equivalent of a depositors’ bank run where distrust in the institution is infectious and immediate. Once trust is lost it is very

¹⁰⁰ Supra note 8, (Schwarcz), 202

¹⁰¹ Ibid, 243-245

¹⁰² It mirrors microcosm communities in nature. For example, see Robert May, ‘Will a large complex system be stable?’, (1972) *Nature*, 238, 413–414 and Jeremy Fox and McGrady-Steed, ‘Stability and complexity in microcosm communities’, (2002) *Journal of Animal Ecology* Vol. 71, 749–756. The researchers found that “the probability that an initial community would be stable and feasible is a function of complexity”. “The more complex the interconnectedness of organisms in a microcosm the greater the probability of structural instability”. See also Daniel Haydon, ‘Maximally stable ecosystems can be highly connected’, (2000) 81 (9) *Ecology*, 2631-2636, who argues that some highly inter-connected ecosystems can remain stable through “self-regulation processes” (page 2632). Separately, there is the concept that some organisations act as “nodal” points and these nodes form points which increase network efficiency but also pose risks of instability contagion. See Yaron Leitner, ‘Financial networks: contagion, commitment, and private sector bailouts’, (2005) *Journal of Finance* Vol. 60, Issue 6, 2925-2953, 2925-2926

¹⁰³ Emiliós Avgouleas, ‘The global financial crisis, behavioural finance and financial regulation: in search of a new orthodoxy’, April 2009) *Journal of Corporate Law Studies*, 23-59, 28

¹⁰⁴ Supra note 54, (Jácome and Nier), 1-6

difficult for it to be regained. Frequently, it requires outside intervention whether by the government or by, for example, J. P. Morgan in halting the panic of 1907.

There have been attempts to distinguish the transmission mechanisms between those that relate to bank balance sheet assets and those that relate to bank capital.¹⁰⁵ In practice, the instability mechanism sweeps backwards and forwards across both sides of bank balance sheets. It may, for example, start with market concerns about bank balance sheet asset values resulting in withdrawals of deposits and short term funding followed by a write-down of other balance sheet asset values which may trigger bond issue clauses and so on.

There are three key elements relevant to the transmission of financial instability through the financial system: the build-up of financial imbalances in the economy, the transmission systems which causes the build-up of these imbalances and how their effects are transmitted to the wider economy.¹⁰⁶ These imbalances will normally be expressed in rapid asset, invariably, property price growth. However, it is the form of financing which is critical to macroprudential policy since an analysis of twenty-three “bubbles” found that debt financing causes the greatest concern.¹⁰⁷ For example, canals and railways financed in the 18th and 19th century in the US and UK by equity had little effect on the wider economy when the issuing companies failed. However, the system is much more likely to fracture if the bubble is financed by debt.¹⁰⁸

The risks to financial stability can be analysed into those which occur over a period of time and those which spread across financial sectors. Those with a “time-series dimensional” develop with the build-up, over time, of financial imbalances. Those with a “cross-sectional

¹⁰⁵ Sami Alpanda, Gino Cateau and Cesaire Meh, ‘A model to analyse macroprudential regulation and monetary policy’, (2014) BIS Working Paper No. 461, 4-6. See also Stijn Claessens, ‘An overview of macroprudential policy tools’, (2014) IMF Working Paper WP/14/214, 5-8

¹⁰⁶ Supra note 71, (Aikman, Haldane and Nelson), 17

¹⁰⁷ Supra, note 11, (Brunnermeier and Schnabel), 22. Highly interconnected financial networks may be “robust-yet-fragile” since connections serve as shock-absorbers [and] connectivity engenders robustness,” supra note 89, (Haldane, ‘Rethinking the financial network’). However, interconnections may be a mechanism for the propagation of shocks, “the system [flips to] the wrong side of the knife-edge,” and fragility prevails. See also Daron Acemoglu and others, ‘Systemic risk and stability in financial networks’, (2015), *American Economic Review* 2015, 105(2), 564, 566. The pro-cyclicality of “mark-to-market” accounting may increase instability, Hyun Song Shin and Tobias Adrian, ‘Liquidity and leverage’, (2008) IMF Financial Cycles, Liquidity, and Securitization Conference Paper

¹⁰⁸ In the build-up to the secondary banking collapse in the early 1970s UK bank borrowing rose by 148% between 1971 and 1973 and bank lending to the property sector rose by over 800% from 1971 to 1974. This was reflected in a rise in the capital valuations of property of some 25% in each of the years 1972 and 1973, Margaret Reid, *The secondary banking crisis, 1973-1975*, (Macmillan Press, London, 1982), 62-63.

dimension” indicate imbalances crossing over into other sectors at a “single point in time due to the interconnections (direct or indirect) of the financial system.”¹⁰⁹ The two aspects of financial instability are clearly linked as “the unwinding of financial imbalances poses more concerns to policymakers if shocks cause strong spill-over effects within a highly connected financial system.”¹¹⁰ This form of analysis would mean that the roles of both the macroprudential and the microprudential authorities are twofold: to have sufficient capital and liquidity buffers to support individual financial institutions through the lesser trials and to provide the management of individual firms and the regulators with time to mitigate the more powerful threats. This is important, since in order to be successful, macroprudential policy needs to have a clear understanding of what is meant so that the right macroprudential structures can be designed and the correct “tools” employed. However, macroprudential policy lacks the clarity of objective, as mentioned earlier, seen in determining monetary policy.

Consequently, financial instability appears to be the norm and that the whole financial structure is inherently fragile and subject to frequent stresses which, depending on a range of factors, have the potential to cause the system’s collapse at any time. This gives the macroprudential policymaker an important but limited role: to keep a look-out for the bigger squalls and to ensure that microprudential regulators take the necessary collective actions. This analysis underpins the subsequent consideration of macroprudential policy. The inherent fragility of the system provides the macroprudential regulator with a constant dilemma of when to exercise its powers and to intervene. This is considered next.

¹⁰⁹ Claudio Borio and William White, ‘Whither monetary and financial stability? The implications of evolving policy regimes’, (February 2004) BIS Working Paper No. 147, 17. See also Claudio Borio and Andrew Crockett, ‘In search of anchors for financial and monetary stability’, (Autumn 2000) *Greek Economic Review*, 20(2), 1 and Charles Goodhart and J Danielsson, ‘The inter-temporal nature of risk’, (2001) 23rd SUERF Brussels Colloquium on ‘Technology and finance: challenges for financial markets, business strategies and policymakers’

¹¹⁰ Gabriele Galati and Richhild Moessner, ‘Macroprudential policy – a literature review’, (2011), BIS Working Papers No. 337, 1. However, it is worth noting that it is difficult to disentangle the perception that risk spreads like a contagion from other views that systemic risk spreads due to many organisations holding similar types of assets, Claudio Borio, ‘Towards a macroprudential framework for financial supervision and regulation?’, (2003) BIS Working Papers No 128, 3, 1. This is due, in part, to the rise in asset valuations which appear to reduce the need to pay as much attention to risk

2.10 When to intervene in the market and discretion in applying macroprudential policy

Since, as mentioned earlier, macroprudential policy is anticipatory and much of its effectiveness comes from the ability of the regulator to “signal” its concerns to the market it is important to intervene as early as possible. However, the indicators of financial imbalance are likely to be confused. For example, the US economy started to turn at the end of 2006 with major problems in the financial markets starting at the end of 2006 and into the spring of 2007, but economic growth continued into 2008.¹¹¹ It is possible that certain lead-indicator ratios such as the increase in credit as a percentage of GDP or rapid asset price inflation should provide the macroprudential regulator with the data to act very early in the financial cycle. However, as discussed later in this chapter this places the regulator in a difficult position in relation to politicians, the financial services industry and borrowers since the start of the financial cycle may not appear to be an issue viewed from the perspective of those looking at the business cycle. In 2005 the then Chairman of the Federal Reserve stated that any central bank intervention to correct “cyclical imbalances” would be too late and “misguided”.¹¹² This was supported by Bernanke and Gertler.¹¹³

There are also questions whether the decision, and the extent to which action is taken, are best determined by inflexible “rules” or, at the other extreme, left wholly to the judgment of the policymaker. If a rules based approach is taken the indicators used and the rules applied need to be transparent and easily understood by the market.¹¹⁴ The FPC does not see itself as constrained by, for example, automatic macroprudential “triggers”. Instead the

¹¹¹ Claudio Borio, ‘The financial cycle and macroeconomics: what have we learnt?’, (2012) BIS Working Papers No. 395, 3 - 5 argues that the “financial cycle” is much less frequent than the “business cycle”

¹¹² Alan Greenspan, ‘Reflections on central banking’, remarks at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 26th August 2005

¹¹³ Supra note 83, (Bernanke and Gertler), 253, who saw the main role of the central bank as remediation action following a collapse in asset prices

¹¹⁴ The Bank for International Settlements’, Committee on the Global Financial System is in favour of a strict rules-based macroprudential regime: “Experience with monetary policy suggests that policymaking works best when it is fairly predictable and transparent. The same is likely to hold true for macroprudential policy. When leaning against the financial cycle, where timely policy action is particularly important, explicit guidelines or well-articulated principles for macroprudential policy actions should help to counter political and institutional resistance.” CGFS, ‘Macro-prudential instruments and frameworks: a stocktaking of issues and experiences’, (2010) CGFS Papers No. 38, 6

committee exercises its judgement in determining policy.¹¹⁵ However, there is a risk that a system based on simplicity misses key factors. “There may also be “softer” factors to take into account using information from the microprudential supervisors (eg increasingly lax underwriting, more frauds, mis-priced risk etc).”¹¹⁶ Moreover, in carrying out any analysis the macroprudential policymaker needs to act with “simplicity and humility” since macroprudential policy “cannot be expected to eliminate the credit cycle”... and macroprudential policy needs to operate with “simple rules augmented by regulatory judgement”.¹¹⁷

The tendency, with macroprudential tools, has been to limit non-discretionary rules to the sphere of capital, liquidity and leverage regulation.¹¹⁸ This approach dovetails with the microprudential rules. In addition, capital requirements fulfil a range of roles (eg to act as a buffer if losses are sustained by the bank, to encourage shareholders to oversee bank management since their investment is effectively held hostage against the undertaking of excessive risk and to act as a price signal to the market as the strategy of the bank develops in the context of economic and market conditions). For example, rules-based dynamic capital provisioning may fulfil this market-signalling function as well as act as a brake on bank asset growth. Much of the success of this approach will depend on how markets read the signals against a background of rapidly rising asset prices, possibly inflated by other sources of credit and finance. It is possible that the signals, in these

¹¹⁵ Paul Tucker, Simon Hall and Aashish Pattani, ‘Macroprudential policy at the Bank of England’, (2013), Quarterly Bulletin, Q3, 192. See also, for example, the many references to the FPC’s “judgement” in The Bank of England’s, ‘The Financial Policy Committee’s framework for the systemic risk buffer’, (May 2016), pages 4, 5 and 6

¹¹⁶ Bank for International Settlements, Committee on the Global Financial System, ‘Operationalising the selection and application of macroprudential instruments’, (2012) CGFS Papers No. 48, 16

¹¹⁷ Supra note 71, (Aikman, Haldane and Nelson), 32

¹¹⁸ Rules have the advantage that once in place they require no further justification and act automatically, Claudio Borio, ‘Implementing a macroprudential framework: blending boldness and realism’, (2010), BIS Paper, 10

circumstances, are too muted and the provisioning required too little.¹¹⁹ Much will depend on how macroprudential regulatory actions are transmitted through the market and into the broader economy. Aspects of this issue are considered later in this chapter. However, it may be the case that capital requirements which attempt to establish a high-level of uniformity across all banks, for example, in terms of the allocation of risk-weights, may in turn encourage a “uniformity of behaviour which is itself a source of instability”.¹²⁰

Moreover, the longer credit controls are in place the greater the risk for avoidance. For example, in Spain while dynamic provisioning was useful in mitigating the credit cycles, credit growth continued as borrowers moved to smaller lenders which were less constrained by provision limits.¹²¹ This issue of avoidance or “leakage” may undermine many aspects of macroprudential policy and is considered in more detail later in this chapter. It is worth noting that leverage ratios are much more difficult to avoid and may have an important market “signalling” effect but may still be ineffective in the face of large amounts of non-banking mortgage lending.¹²² Consequently, it is against this background of uncertainty and serious policy disagreements that a subsequent section of this chapter considers the issues involved in the design and application of macroprudential policy. However, before turning to this it is important to reflect upon an important aspect of what may be described as both macroprudential policy “hubris” and its perceived vulnerabilities. Macroprudential policy seeks to establish control using a variety of powerful “tools” but at the same time sees, as in the example of Spanish dynamic provisioning mentioned earlier,

¹¹⁹ Financial Stability Board, ‘Peer review of Spain’, (January 2011), 5, “[T]he Spanish dynamic pre-provisioning scheme ... was a well-designed counter-cyclical measure, but of insufficient scale and extent to provide much of a mitigant to the Spanish housing cycle.” Charles Goodhart, ‘Lessons for monetary policy from the Euro-area crisis’, (2013), 4, Bank of Greece conference on ‘The crisis in the Euro-area’, in Athens, on 23rd-24th May 2013. See also Dirk Schoenmaker and Peter Wierdsma, ‘Macroprudential supervision from theory to practice’, (February 2016), National Institute Economic Review No. 235, R50, R56-57. See also Mathias Dewatripont and Jean Tirole, ‘Macroeconomic shocks and banking regulation’, (December 2012), Journal of Money, Credit and Banking, Vol. 44, 237, 249. Eliana Balla and Andrew McKenna, ‘Dynamic provisioning: a countercyclical tool for loan loss reserves’, (Fall 2009), Economic Quarterly, Vol. 95, No.4, 383, 386

¹²⁰ Supra, note 70, (Landau), 5

¹²¹ Gabriel Jiménez and others, ‘Macroprudential policy, countercyclical bank capital buffers and credit supply: evidence from the Spanish dynamic provisioning experiments’, (2015) Working Paper, Universitat Pompeu Fabra

¹²² Emiliós Avgouleas, ‘Bank leverage ratios and financial stability: a micro and macroprudential perspective’, (October 2015) Levy Economics Institute, Bard College, Working Paper No. 849, 24-25

the effect of these mechanisms become less potent. The issues of “hubris” and failure are considered next.

2.11 Macroprudential policy and the concept of the “turbulent frontier”

As mentioned earlier, the concept of the “turbulent frontier” used in the context of geopolitics, lends itself to an analysis of financial services regulation, in general, and macroprudential policy, in particular. In its original form the analysis of the “turbulent frontier” puts forward the proposition that provincial “governors, charged with the maintenance of order, could not ignore disorder beyond their borders” and consequently, they took action “to eliminate the disorderly frontier” which “in turn produced new frontier problems and further expansion”.¹²³ In developing this idea in regulatory policy, as well as geopolitical terms, there probably need to be other dynamics in operation including sufficient “turbulence” and factors which “push and pull” towards intervention and action.¹²⁴ The “turbulent frontier” concept is particularly appropriate when the governor’s power is increasing. This growth of power leads to a concern “with everything that happens anywhere” and the need to protect the ever expanding frontier is “a process with few natural limits.”¹²⁵ It is compounded by the perception that regulators are very ready to perceive instances of “market failure” based on their tendency to have a “latent distrust of market system” solutions and hence to favour regulation and direct intervention in the market.¹²⁶

First there needs to be “turbulence”. In terms of financial services this may take the form of some threat to financial equilibrium. For example, it could involve a rapid expansion of credit in a new and growing area such as “buy-to-let” properties. Macroprudential policy would indicate the need for data, the acquisition of regulatory powers over this area and possibly macroprudential action in the form of a recommendation to microprudential

¹²³ Supra, note 16, (Galbraith), 168

¹²⁴ Susan Woodward, ‘The long intervention: continuity in the Balkan theatre’, (December 2013) Review of International Studies, Vol. 39, Issue 5, 1169, 1172-1173

¹²⁵ Robert Jervis, ‘Unipolarity: a structural perspective’ in John Ikenberry, Michael Mastanduno and William Wohlforth (eds), *International relations theory and the consequences of unipolarity*, (Cambridge University Press, Cambridge, 2011), 265-266

¹²⁶ Thomas Barthold, ‘Issues in the design of environmental excise taxes’, (1994) Journal of Economic Perspectives, Vol 8, No.1, 133, 143

supervisors. Second, there would need to be some “push” for macroprudential intervention. This could come from individual members of the FPC or from the Treasury Select Committee or wider government and media interest. A Deputy Governor of the Bank of England would want to avoid being described, in public by, for example, the Treasury Select Committee as “being asleep at the wheel.”¹²⁷

The issue of the “turbulent frontier” also applies to microprudential and conduct of business policy where there is always one more area to be regulated. This can be seen in the UK as over the years conduct of business regulation has spread from investment business to general insurance to first charge residential mortgages to retail banking business to unsecured credit to “crowd funding” to second charge and buy-to-let mortgages and so on. However, in most instances, the drive to regulate these areas has not been “pushed” by the regulator. Instead the initiatives have largely come from politicians, machinery of government restructures (ie the demise of the Office of Fair Trading and the transfer of responsibility for most aspects of unsecured lending to the FSA) and EU legislation. In some cases the regulator has expressed reluctance to take on these new responsibilities. This is particularly true when the FSA was assigned responsibility for aspects of competition regulation.¹²⁸

Similarly, macroprudential policy has no boundaries and there is no reluctance to expand its frontiers. As described above, there is sufficient evidence of both policy push and pull, incrementally, to extend the purview of macroprudential policy frontier by frontier. This approach contains the risk of over-reach as “policymakers may soon find themselves extending the range of measures and inadvertently drift into credit allocation. And the temptation to resort to capital controls to underpin macroprudential instruments could at some point become quite strong...”¹²⁹

¹²⁷ Questions to Sir John Gieve, (Deputy Governor Responsible for Financial Stability) regarding the Bank of England’s role in failing to prevent the collapse of Northern Rock, (oral evidence on 20th September 2007), question 6-8

¹²⁸ Andrew Whittaker (FSA’s General Counsel), ‘The role of competition in Financial Services Regulation’, (speech given on 21st April 2001, paragraph 16, “[having a competition objective] would not only mean that we had an unclear and confusing mandate. It would also make it more difficult for us to be held to account for achieving our objectives. For example, if we set capital requirements too low, it would always be open to us to say that we had needed to do this in order to pursue our competition objective.”

¹²⁹ Claudio Borio, ‘Macroprudential frameworks: (too) great expectations?’, (August 2014), 25th anniversary edition of Central Banking Journal, 4

A wide-ranging perspective is undoubtedly correct but an overly large scope may be to expect too much from one committee however expert. Reflecting the Roman Empire's "Tetrachy" it may be more appropriate to segment macroprudential risks by, for example, the immediacy of the potential threats or type of issue. There could be a committee concerned with leverage and asset prices, another committee could focus on protecting the payments systems and cyber-security and a third committee could consider long-term issues such as demographics and climate change. Finally, a fourth committee would need to concern itself with identifying institutions and markets not currently subject to regulatory oversight and microprudential supervision where risks of instability may be forming. These committees would need to be coordinated both with each other but also with monetary, fiscal and microprudential policy.

In addition to the "turbulent frontier" concept there are a number of other broad issues with macroprudential policy. These are considered in the next section.

2.12 Limitations on the use of macroprudential policy

The issues with macroprudential policy generally arise if macroprudential policy is viewed simply as a grander version of microprudential regulation or solely as a branch of economic modelling. Specifically, they include:

- political and institutional legitimacy and the closely-aligned concerns over accountability,
- the relationship with microprudential regulation,
- the limited consideration given to conduct of business regulation in the macroprudential context,
- the excessive expectations placed on macroprudential policy,
- the extent to which macroprudential policy can be "fine-tuned",
- failure of macroprudential policy to consider the wider economic and societal issues,

- the effectiveness of some of the tools and the potential for unintended consequences arising from any regulatory intervention across all, or a sector, of the financial services industry.

The next sections consider each of these concerns in more detail.

2.12.1 Political and institutional legitimacy

Macroprudential policy can impinge on the political sphere and have political implications. For example, what appear to be technical changes at the microprudential level may have clear macroeconomic consequences as soon as their visibility is raised as macroprudential policy. “Macroprudential policy may not be fully implemented due to political constraints and therefore during a crisis more stringent brakes are applied with consequent more political interference... [and it is] a balancing act to counter political headwinds and to retain democratic legitimacy.”¹³⁰ This issue is considered in more detail in **chapter 6**.

In part, institutional and operational legitimacy rests on adequate accountability which in turn requires transparency and openness supported by reasoned arguments based on fair and consistent process.¹³¹ However, this may pose severe problems for macroprudential policy which is designed to stifle “euphoric” booms. Consequently, there is a risk that it may be politically expedient to use less publicly obvious, highly technical macroprudential measures since they will attract the least public and political attention. It is less acceptable politically if the costs are seen to be immediate but the benefits of financial stability are less apparent.¹³² Further, as this thesis argues more use should be made of conduct of

¹³⁰ Viral Acharya, ‘Financial stability in the broader mandate for central banks: a political economy perspective’, (2015) Hutchins Centre on Fiscal and Monetary policy at Brookings, Working paper No. 11, 4 and 12

¹³¹ Rosa Lastra, *Central banking and banking regulation*, (London School of Economic, Financial Markets Group, London, 1996), 53

¹³² Supra, note 126, (Barthold), 143, This paper discusses the political implications of taxing pollution. There are parallels between financial stability regulation and environmental protection legislation since there are a wide variety of regulatory strategies available to influence markets. These range from imposing indirect costs on polluting industries by raising their cost of capital to direct prohibitions on polluting activities, for example, to protect rivers used by local residents and tourists. Politically the option of using “Pigouvian” taxation of polluting activities to reflect the externalities of pollution is the least attractive option. Raising the cost of capital is much more acceptable in political terms since it less obviously causes prices to rise. Direct prohibitions can also be popular with voters since, again, the causal effect on prices is hidden. See also Maureen Cropper and Wallace Oates, ‘Environmental economics: a survey’, (1992) *Journal of Economic Literature*, Vol. 30, 675, 685

business regulation employed in a macroprudential role since it is less likely to raise concerns over political legitimacy.

2.12.2 Relationship between microprudential and macroprudential policy

Almost all the macroprudential “tools” operate, in practice, at the microprudential level whether these are, as mentioned earlier, structural or cyclical. The macroprudential policymaker is dependent on the microprudential regulator for information on what is happening with individually regulated financial institutions and for the implementation of macroprudential policy. This level of dependency is a major reason influencing the appropriate regulatory structure and the co-location of the macroprudential and microprudential authorities, for the most significant firms, in the UK.

Macroprudential regulation could be undertaken by the microprudential regulator. However, as described at the start of this chapter, macroprudential policy is a state of perception. It requires a separate body to think differently, in the context of a set of broad macroprudential objectives and to select the appropriate “tools” to be applied by the microprudential regulator. Further, as mentioned above, while microprudential regulators normally need to be taciturn and discreet, frequent and clear communication is an important element in role of the macroprudential regulator. This is an aspect that has still to be developed by all macroprudential authorities as will be seen in chapter 3.

2.12.3 The limited consideration given to conduct of business regulation

Regardless of whether the discussion of macroprudential policy originates, for example, from the FPC, IMF or Bank of International Settlements, almost no mention is made of the policy’s relationship with conduct of business regulation. For example, macroprudential policy is seen as reducing, or controlling, the supply of credit to an over-heating economy. However, there is little, if any, discussion of the use of conduct of business regulation to limit the demand for credit.¹³³ To a certain extent this can be seen as the role of monetary

¹³³ For example, the Financial Policy Committee’s (FPC) minutes are limited to noting that “tighter underwriting standards were also being introduced as part of the FCA’s Mortgage Market Review (MMR)”. ‘Record of the Financial Policy Committee meeting held on 20th November 2013’, paragraph 14, 5. There is also a reference to using the MMR interest rate stress tests to improve underwriting standards, ‘Record of the Financial Policy Committee meeting held on 19th March 2013’, paragraphs 10 and 11, 4

policy but, as will be seen later, the latter can best be described as a blunt instrument compared to a more nuanced approach available through the use of conduct of business regulation. More recently, the FPC has briefly noted that the affordability test “constrains the size of mortgage obtainable relative to incomes”.¹³⁴ Further, the FPC sees an important role for its power to designate the interested rate to be used in undertaking affordability calculations and its monitoring of economic indicators to identify structural problems early.¹³⁵ However, this fails to recognise that the conduct of business regulations require the lender to look in detail at the financial position of the potential borrower, going well beyond matters relating to their income and interest rate forecasts. The conduct of business regulations have the ability to act as a powerful macroprudential “tool” which both protects consumers by restricting their ability to borrow with the corollary of reducing demand for credit. The effect of this is to limit asset price growth and debt generally. Whether this is an appropriate macroprudential “tool” is central to this thesis. It is an issue which is addressed further later in this and in subsequent chapters.

2.12.4 Excessive expectations

There are high expectations placed on the post-financial crisis regulatory structures both in preventing another crisis and mitigating the damage when a further problem develops. The macroprudential policymaker is the first line of defence with the task of identifying a potential issue at a very early stage and, using the apposite clichés, turning off the dance-music or taking away the punch-bowl.¹³⁶ The ability to do this in the face of what will be political, industry and popular sentiment is recognised but remains untested. There are likely to be many “false positives” where the metrics indicate the start of an asset price

¹³⁴ FPC minutes 23rd and 29th November 2016, 6

¹³⁵ Bank of England, ‘Financial Stability Report’, (June 2017), 13. Similar wording is contained in the FPC minutes of 21st June 2017, (4th July 2017), 9 and 10

¹³⁶ The “dance” analogy refers to comments by Chuck Prince (Citigroup CEO) on the eve of the recent collapse of global financial markets when he “dismissed fears that the music was about to stop for the cheap credit-fuelled buy-out boom”, saying that Citigroup was “still dancing” in an interview with the Financial Times. “The party would end at some point but there was so much liquidity it would not be disrupted by the turmoil in the US subprime mortgage market. When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.” (Financial Times, 9th July 2007)

The ‘punch-bowl’ reference is attributed to a speech made in 1955 by William McChesney Martin, Chairman of the Federal Reserve Board, in which he said that the role of the Federal Reserve was to remove the punch-bowl at a party just when the party was really warming up because there are economic danger signals in sight. The quotation has been repeated many times by others over the years.

“bubble” which fails to develop in the classic Minsky/Kindleberger model. Macroprudential action may result in what may appear to be the premature demise of an economic boom to politicians, the financial services industry and the general public. It would be a severe test of the creditability and hence, perversely, of the legitimacy of the macroprudential policymaker. A financial crisis prevented will gain the latter little credit. This issue has been recognised but has not really been addressed.¹³⁷

2.12.5 Regulatory “fine-tuning”

There is also a risk that targeted macroprudential actions would appear to be an attempt to replicate policies in the 1960s and 70s to “fine-tune” the economy. This system of trying to manage the economy failed due to the complexity of the system.¹³⁸ Much of this failure was due to misconceived economic models and entrenched powerful interest groups.¹³⁹ It is likely that there are too many factors in macroprudential policy to be able, mathematically, to model all the interactions.¹⁴⁰ Haldane makes a broadly similar point in another area of financial regulation.¹⁴¹ This is not a reason for failing to try to use macroprudential policy but the belief that it is susceptible to “fine-tuning” may only result in further unpredictable distortions to the financial system.

¹³⁷ Supra note 3 (Goodhart, ‘The macro-prudential authority’), 19 and supra note 2, (Haldane, ‘Macroprudential policies’), 4

¹³⁸ G. C. Peden, ‘New revisionists and the Keynesian era in British economic policy: a comment’, (2003) *Economic History Review*, LVI, 1, 118, 122-123

¹³⁹ Kathleen Burk and Alec Cairncross, *Goodbye Great Britain: the 1976 IMF crisis*, (Yale University Press, New Haven, 1992), 209-212

¹⁴⁰ These models have been heavily criticised for ignoring the important role of banks and their part in the intermediation process, Charles Goodhart, Dimitrios Tsomocos and Martin Shubik, ‘Macro-modeling, default and money’, (2013), London School of Economics, Financial Markets Group Special Paper 224, 3. However, Matthias Salge takes the opposite view in *Rational bubbles: theoretical basis, economic relevance, and empirical evidence with a special emphasis on the German stock market*, (Lecture Notes in Economics and Mathematical Systems, Springer, Berlin and Heidelberg, 1997)

¹⁴¹ Andrew Haldane, ‘The dog and the frisbee’, at the Federal Reserve Bank of Kansas City’s 36th economic policy symposium, ‘The changing policy landscape’, Jackson Hole, Wyoming, 31st August 2012

2.12.6 Failure of macroprudential policy to consider the wider economic and societal issues

Reading the extensive literature on macroprudential policy, mainly written after the recent financial crisis, one is struck by the narrow focus of almost all the documents.¹⁴² There is a void when it comes to considering the possible interaction of macroprudential policy on wider economic and societal issues. In part this is probably due, as mentioned above, to the approach taken by economists developing mathematical economic models.¹⁴³

This complexity is recognised by microprudential regulators who have started to view “their flock” of regulated firms not just as a set of accounting numbers but as complex organisations with operations and processes, systems of governance and interactions with other bodies. In addition, over-arching all this are the foibles and drivers of individual actions within these firms. To an extent, for banks, microprudential regulation derived from Pillar 2 of the Basle III regulatory regime, seeks to address these aspects of risks. Macroprudential policy has still to consider, evaluate and decipher this broader canvas. For example, the macroprudential policymaker needs to appreciate that the interaction between credit and housing is not just a narrow economic assessment but requires an understanding of the housing market, why demand for housing exists and how it might be satisfied.

By restricting regulation to simply limiting the provision of credit other financial instabilities may be generated with the potential to threaten financial stability: the steam will still escape from the pressure cooker. In practice this means that the macroprudential authorities need to widen their view by considering other relevant factors such as the supply of housing. This means employing experts who can provide information and advice on, for example, housing markets, derivative asset pricing, commercial property etc in a search for areas of potential financial imbalance that could result in financial instability. It requires macroprudential policy to take a wider perspective including providing advice on fiscal matters. These aspects are considered in more detail in chapters 6 and 8. It would also be worthwhile to look at the approaches employed in other jurisdictions. Examples of

¹⁴² Supra, note 59, oral evidence given by Jacques De Larosi re to the House of Lords Committee

¹⁴³ Supra, note 140, (Goodhart, Tsomocos and Shubik), 3. See also Philipp Hartmann, ‘Real estate markets and macroprudential policy in Europe’, (May 2015) European Central Bank Working Paper No. 1796, which advocates the use and effectiveness of LTV and DTI measures but fails to mention the legitimacy deficit issue

this include the concept of the “qualified mortgage” and the role of the Veterans Administration in the US. These are both analysed in chapters 5 and 7 respectively.

2.12.7 Effectiveness and unintended consequences

Macroprudential policy is so little understood that its collateral effects are largely unknown. In parallel, its effectiveness in open trading economies is still unclear. For example, macroprudential measures may have an effect on competition. They may increase barriers to entry and exit from the industry and hence reduce competition. There is some evidence that competition increases bank risk-taking as margins are restricted.¹⁴⁴ Conversely, other studies indicate that increased competition may reduce risk.¹⁴⁵ However, it is clear that the data supports the hypothesis that when banks are faced with more intense competition, they gravitate towards higher levels of leverage.¹⁴⁶

Although this is not evidenced there is also a risk that business, subject to macroprudential constraints, may shift to non-regulated areas. There is a related risk that attempts to restrict the growth in credit will result in some of the demand being supplied by lenders beyond the jurisdiction of the macroprudential regulator, known as the risk of “leakage”. In 2012 the Bank for International Settlements’ Committee on the Global Financial System (CGFS) suggested that in order to prevent the risk of “leakages” to foreign lenders, “LTV caps [should be] deployed ... through ‘conduct [of business] rules’”.¹⁴⁷ However, the CGFS did not develop this point. This perspective is a central to this thesis and is addressed in

¹⁴⁴ Michael Bordo, Angela Redish and Hugh Rockoff, ‘Why didn’t Canada have a banking crisis in 2008 (or in 1930, or in 1907 or...)?’, (2011), National Bureau of Economic Research Working Paper 17312

¹⁴⁵ John Boyd, Gianni De Nicolò, and Abu Jalal, ‘bank risk-taking and competition revisited: new theory and new evidence’, (2006) IMF Working Paper WP/06/297, 29. See also John Boyd, Gianni De Nicolò, and Elena Loukoianova, ‘Banking crises and crisis dating: theory and evidence’, (2009) IMF Working Paper WP/09/141, 19. There may also be a balance between faster economic growth and financial stability due to patterns of “creative destruction” and better allocation of resources, Thorsten Beck, ‘Competition and financial stability: friend or foe’, (2008) The World Bank, Policy Research Working Paper 4656. Nevertheless, the generally accepted view is that there is a trade-off between competition and financial stability which can be characterised as a conflict between the longer-term efficient allocation of resources in Schumpeterian terms and the risk of shorter term dislocation to the broader economy, Franklin Allen and Douglas Gale, ‘Competition and Financial Stability’, (2004) Journal of Money, Credit and Banking 36(3) Part 2, 453, 473 and 478

¹⁴⁶ *supra*, note 65, (Hanson, Kashyap and Stein), 22

¹⁴⁷ *Supra* note 116, (CGFS Papers No. 48), n29 and 38

the next section and in subsequent chapters as part of an examination of macroprudential tools and their efficacy.

2.13 Consumer protection

The protection of consumers from over-borrowing benefits not just the individual but also helps to ensure the stability of the financial system. It is likely to reduce the rapid expansion of credit and the commensurate increase in asset values. At the same time as reducing the probability of financial instability it lessens the potential costs of an economic downturn since there will be fewer non-performing loans, reduced provisioning and assets prices will be stronger with less risk of property fire-sales. However, the use of conduct of business regulations is rarely mentioned, if at all, in the studies of macroprudential tools.¹⁴⁸

Conduct of business policies are generally accepted and are not challenged on grounds that they lack public “legitimacy”. Conversely, for example, Taylor makes the point that macroprudential policies, particularly in housing, would have taken “the [Federal Reserve] into political controversy”.¹⁴⁹ This latter issue is a factor deterring the use of LTV and LTI macroprudential policies and is discussed in more detail in chapter 6. Second, the conduct of business regulations apply to the mortgage as a transaction or product. However, LTV and LTI policies normally operate in respect of particular institutions and may be avoided by out-of-scope lenders.¹⁵⁰

As already mentioned as a property boom gets underway credit standards weaken for a number of reasons including the belief that asset prices will only continue to rise and if the

¹⁴⁸ For example, conduct of business regulation was not mentioned by Jon Cunliffe (Deputy Governor Financial Stability at the Bank of England) in a speech on macroprudential policy options, ‘Credit: can trees grow to the sky?’, (9th February 2016 speech at the British Property Federation Annual Residential Investment Conference, London)

¹⁴⁹ John Taylor, ‘Simple rules for financial stability’, Keynote address at the Financial Markets Conference ‘Maintaining financial stability: holding a tiger by the tail’, Federal Reserve Bank of Atlanta, 9th April 2013.

¹⁵⁰ ‘Prudent mortgage lending standards help ensure financial stability’, Luci Ellis (Head of Financial Stability Department), address to the Australian Mortgage Conference, Sydney, 23rd February 2012, 6. See also Vítor Constâncio, Vice-President of the ECB, in a speech at a conference on ‘The macroprudential toolkit in Europe and credit flow restrictions’, organised by Lietuvos Bankas, Vilnius, 3rd July 2015, stating that macroprudential tools need to apply to any institution providing mortgage credit

borrower fails to service the debt rising property prices will protect the lender from loss.¹⁵¹ Most of the regulatory responses, as noted in this chapter, have been to consider the more conventional macroprudential policies. However, it is worth noting that both Australia and Germany have identified the importance of existing conduct of business regulations as macroprudential policies. The Reserve Bank of Australia's Head of Financial Stability considered the importance of conduct of business rules to protect financial stability, "in Australia, the previously state-based but uniform consumer credit code was reformed and brought under national control in 2009. The range of products covered was broadened, and the suitability tests that lenders must apply were tightened. However, this reform was not motivated by financial stability considerations, and the previous system already had the features needed to avoid a systemic deterioration of lending standards beyond the point of prudence."¹⁵² She saw the borrower's capacity to service their mortgages as more important than property prices and LTV ratios and conduct of business regulation forming a "second line of defence" to assist macroprudential policies.¹⁵³ Moreover, LTV measures can also be seen as "indicators of relative risk" since high LTV levels can be viewed as both predictors of the probability of lenders mortgage losses and the extent of such loss levels.¹⁵⁴

Similarly, the German Financial Stability Commission, in addition to LTV and LTI measures, recommended that lenders "conduct a credit assessment of potential borrowers by measuring their debt service capacity and the recoverable value of their collateral. This

¹⁵¹ William Bassett and others, 'Changes in bank lending standards and the macroeconomy', (2014) *Journal of Monetary Economics*, Vol. 62, 23, 38

¹⁵² Luci Ellis, 'Macroprudential policy: What have we learned?', paper at the Bank of England's Centre for Central Banking Studies Workshop, London, 6th March 2013, 3. Ellis is skeptical about the ability of LTV limits to prevent financial instability due to the ease of avoidance, problems with ascertaining the value of property in a housing boom and the effect of LTV caps on first time buyers, 'Macroprudential policy: a suite of tools or a state of mind?', speech by Luci Ellis at Paul Woolley Centre for the Study of Capital Market Dysfunctionality Annual Conference, Sydney, 11th October 2012

¹⁵³ Supra note 150, (Luci Ellis 'Prudent mortgage lending standards') 7, "There are quite a few mortgage lenders that are not prudentially supervised, though, and this is where an important second line of defence comes in. Consumer protection standards around credit are a vital part of the authorities' defence against a US-style outcome, a part that in my view has been under-appreciated to date."

¹⁵⁴ Eric Kolpfer, 'A mortgage insurer's look at Basel II and residential mortgage credit risk', (September 2002), *Housing Finance International*, Vol. 17, Issue 1, 22-32, 23

helps to reduce the probability of default on residential real estate loans”.¹⁵⁵ However, it considers that “such credit assessments are difficult to measure or quantify precisely, which means they cannot be used as a macroprudential instrument”.¹⁵⁶

In summary, conduct of business regulations, if properly applied and enforced, like monetary policy, can “get into all the cracks”. Regulation, such as the FCA’s Mortgage Market Review, apply, considered in detail in chapter 4, to the lending transaction. They do not depend on whether the lender is prudentially supervised. The regulations are “always on” and do not require activation. Moreover, as a consumer protection measure, it has inherent public support and consequent “legitimacy”. However, its effectiveness depends on the adequacy of the conduct of business supervision and its enforcement. These issues are considered further in chapters 4 and 5.

As mentioned earlier, there is a hierarchy of instruments which may be used to effect macroprudential policies. Monetary and fiscal policies may have the broadest consequences and these are considered in the next section. The focus of these policies increases with what may be termed the more “traditional” macroprudential “tools” followed by microprudential actions which target specific regulated organisations. As mentioned above, consumer protection policies fall outside the realm of traditional macroprudential policies but they should not be neglected since they may be very effective in curbing credit growth: at the same time protecting borrowers and delivering macroprudential policy objectives. However, it is worth noting that research by the Central Bank of Ireland indicates that affordability tests may, nevertheless, be undermined by periods of low

¹⁵⁵ German Financial Stability Committee, ‘Recommendation on new instruments for regulating loans for the construction or purchase of residential real estate’, 30th June 2015, AFS/2015/1. On the basis of section 3 (2) of the Act on Monitoring Financial Stability of 28 November 2012 (Federal Law Gazette I, page 2369), as amended by article 21 of the Act of 4 July 2013 (Federal Law Gazette I, page 1981) (Financial Stability Act), permits the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, “BaFin”).... to impose restrictions on...granting loans to build or acquire domestic residential real estate secured by a mortgage, should such restrictions be necessary to curb the threat of a disruption to the functional viability of the financial system or any threat to financial stability in Germany.”

New regulations came into force in January 2013 setting up the German Financial Stability Committee (Ausschuss für Finanzstabilität). The Bundesbank, BaFin and the Federal Ministry of Finance (BMF) are all represented on the Committee and the Bundesbank provides the secretariat. The Committee considers issues relating to financial stability and is able to issue warnings or recommendations to German regulators. See also Deutsch Bundesbank, ‘Financial Stability Review 2015’, 79

¹⁵⁶ Ibid, (German Financial Stability Committee, ‘Recommendation on new instruments’), 9

interest rates and rapid rises in house prices.¹⁵⁷ Here, the number of new mortgages rose from 80,000 in 2000 to over 120,000 by 2005 with house prices rising on average by almost 65% over the same period.¹⁵⁸ Mandatory interest rate stress tests, as required by the MMR in the UK may reduce this risk.

The next sections look at the design of macroprudential policy and the types and range of tools available from which policymakers can choose.

2.14 The macroprudential policy framework

As mentioned, macroprudential policy differs from microprudential regulation in that the former is, in practice, a set of broad objectives and has a number of methods which may be employed most of which are derived from, or match, those used by other forms of regulation. An analysis of the macroprudential “tools” and the effectiveness of those focused on LTV and DTI is set out later.

The starting point came in November 2010, when the G20 Leaders “called on the FSB, IMF and BIS to do further work on macroprudential policy frameworks...”.¹⁵⁹ Subsequently, the Bank for International Settlements’ Committee on the Global Financial System suggested seven principles for the design and operation of macroprudential policy”.¹⁶⁰ These include ensuring that there is a strong macroprudential regulator with “strong accountability” and clear objectives. This organisation needed to collect and analyse data from the markets and microprudential supervisors and “[understand] the interconnectivity of markets and financial institutions, both domestically and cross-border” and co-operate with other cross-border agencies. The authoritative macroprudential regulator needed to develop “both traditional and less familiar macroprudential tools” and have a strong “communication strategy” setting out policies linked to ensuring financial stability and to “manage public expectations about what can be achieved with macroprudential policy”.¹⁶¹

¹⁵⁷ Yvonne McCarthy and Kieran McQuinn, ‘Credit conditions in a boom and bust property market’, (October 2013), Central Bank of Ireland Research Technical Paper 8/RT/13, 5

¹⁵⁸ Ibid (McCarthy and McQuinn), 6

¹⁵⁹ FSB, IMF and BIS, ‘*Macroprudential policy tools and frameworks progress report to G20*’, October 2011, 3

¹⁶⁰ Supra note 116, (CGFS Papers No. 48), 40-42

¹⁶¹ Supra note 116, (CGFS Papers No. 48), 40-42

The macroprudential regulator will usually rely on the microprudential supervisors to implement and enforce the designated tools. Systemic risk changes over time.¹⁶² Consequently, it will need to adapt the use of these tools to counteract growing vulnerabilities in the financial system by assessing the two key dimensions of risk mentioned earlier: cross-sectional and time series.¹⁶³

2.15 Conclusion

As discussed, the importance of macroprudential policy can be seen in the clear linkages between credit growth, the housing market and financial instability. By limiting the escalation of credit in the economy, macroprudential policy can assist in protecting financial stability. However, macroprudential policy is predicated on its ability to identify, sufficiently early, potential risks to financial instability and root causes and to deploy the necessary macroprudential tools in time and to effect. The evidence that this would happen is not robust. Further, these concerns are increased by the possibility that the risks to financial stability may manifest themselves in areas beyond the regulatory perspective.

Moreover, there are a number of fundamental issues with macroprudential policy. These include: the political legitimacy of macroprudential policy; how it relates to microprudential and conduct of business regulation; the need to manage excessive expectations; and to recognise that macroprudential policy cannot be “fine-tuned”. Further, macroprudential authorities need to consider their ability to cooperate and the wider economic and societal issues and the effectiveness of some of the macroprudential tools and their potential for unintended consequences.

Although discussion of macroprudential policy goes back to at least the early 2000s, the difficulties inherent in this form of regulation, coupled with a reluctance to interfere when asset prices rose rapidly, meant that it took the recent financial crisis for its importance to be fully recognised. Again, as has been stated, macroprudential policy is at a very early stage. Nevertheless, there are dangers that it may become too narrowly focused or,

¹⁶² Xavier Freixas, Luc Laeven and José-Luis Peydró, *Systemic risk, crises and macroprudential regulation*, (MIT, Massachusetts, 2015), 259; supra note 110, (Borio, ‘Towards a macroprudential framework’), 10-12; supra note 9, (Bank of England, ‘Instruments of macroprudential policy’), 10-17

¹⁶³ Douglas Elliott, ‘Choosing among macroprudential tools’, (2011) The Brookings Institution, 4. See also IMF, FSB, BIS, ‘Elements of effective macroprudential policy’, (31st August 2016), 4

alternatively, policymaking always needs to be on the move to subdue one more “turbulent frontier” after another. To avoid this happening it needs to address a range of issues both conceptual and operational. Those relating to the efficacy of the suite of macroprudential instruments is considered in the next chapter.

Chapter 3

Macroprudential Policy Instruments

“The amount of credit created and its allocation is too important to be left to bankers” ¹

3.1 Introduction

It is tempting to see macroprudential policy as the answer to everything and macroprudential tools have been described as “a gleaming new armoury for policymakers.”²

This chapter reviews the main macroprudential “tools”: the instruments available to the macroprudential policymaker. These include monetary, macroprudential and microprudential policies. All have roles to play in implementing macroprudential policy and it is possible to envisage these elements as three concentric rings forming an archery target. Monetary policy would provide the outer circle, followed by macroprudential policy as you move towards the middle with highly focused microprudential policy in the centre. These policies have also been described as a “hierarchy of instruments” with monetary policies employed before macroprudential measures.³ The use of fiscal measures by government may sit outside this “hierarchy of instruments”.

Consequently, this chapter considers the role of monetary policy as a macroprudential instrument. As mentioned, there are aspects of fiscal policy, in particular, the use of taxation which may function as macroprudential measures and these are also considered in this chapter. At the same time microprudential and macroprudential tools are often interchangeable. This chapter will include an assessment of the close, and often

¹ Adair Turner, *Between debt and the devil*, (Princeton University Press, Princeton, 2015), 104

² Independent Economists Group Report, ‘The role of macroprudential policy in the policy framework’, (June 2014), 5

³ Jaime Caruana and Benjamin Cohen, ‘Five questions and six answers about macroprudential policy’, (April 2014), Banque de France, Financial Stability Review, No. 18, 15 - 23, 19

overlapping, relationship between macro and microprudential regulation.⁴ Finally, this chapter examines the effectiveness of some of the tools and the potential for unintended consequences arising from any regulatory intervention across all, or a sector, of the financial services industry.

The key issue is the workings of the transmission system from macroprudential policies through the financial system and their effectiveness in reducing systemic risk, their efficiency in achieving this goal without a “significant adverse effect on the capacity of the financial sector to contribute to ...economic growth” over the medium to long-term and the transparency of the “nature and use” of the tools.⁵ Understanding these mechanisms has been described as “still in its infancy”.⁶ However, the communication of macroprudential actions is recognised as salient since the management of market expectations is important and “signaling is the key transmission channel”.⁷

All these instruments are capable of controlling the growth of credit since the lesson “for policymakers ... [is that] history demonstrates that they ignore credit at their peril.”⁸ Conceptually, these tools can be divided into two groups: first, those which work by increasing the cost of lending but leave it to the management of individual banks to decide how to manage and respond to these factors and, second, those which are more prescriptive such as the setting of LTV and DTI limits. Although this chapter considers a broad spectrum of macroprudential tools its focus is on policies relating to this latter group which operate via a form of macroprudential policy “diktat”.

⁴ In the UK microprudential regulation refers to the need to “promote the safety and soundness of the firms it regulates, focusing on the adverse effects that they can have on the stability of the UK financial system”, Prudential Regulation Authority, ‘approach to banking supervision’, June 2014, 1. This reflects, for example, Basel Committee on Banking Supervision, ‘Core principles for effective banking supervision’, (September 2012). See also Jacek Osiński, Katharine Seal, and Lex Hoogduin, ‘Macroprudential and microprudential policies: toward cohabitation’, (2013) IMF Staff Discussion Note 13/05

⁵ Chapt 2, n9, (Bank of England “Instruments of macroprudential policy”)

⁶ Chapt 2, n71, (Aikman, ‘Curbing the credit cycle’), 32

⁷ Ibid (Aikman and Haldane), 31. This paper states that macroprudential regulators need to act with “simplicity and humility” since macroprudential regulation “cannot be expected to eliminate the credit cycle”. See also the paper presented by Andrew Haldane in which he makes a similar case for simplicity in financial regulation, Chapt 2, n141, (‘dog and the frisbee’)

⁸ Chapt 2, n47, (Schularick and Taylor, ‘Credit booms gone bust’), 1058

In particular, this chapter looks at the approaches taken in employing LTV and DTI policies, issues with their use and their effectiveness both generally and in selected jurisdictions. Depending on the economic conditions it appears that LTV and DTI limits on their own do not work for long due to what are known as “leakages” as both lenders and borrowers find ways around the restrictions. Some of these methods involve the use of overseas funding. This reinforces the need for macroprudential policies to be co-ordinated across borders. As considered later, a central theme of this thesis is that while LTV and DTI policies should not be dismissed they should be employed in conjunction with conduct of business measures to help restrict the growth of credit in order to avoid unmanageable financial instability.

3.2 Types of macroprudential instruments

This section considers the types of macroprudential instruments. Macroprudential tools fall into two main categories: structural (eg capital and liquidity) and cyclical (eg countercyclical capital buffers and LTV and DTI limits).⁹ The former are aimed at “building structural resilience in the financial system throughout the business cycle.”¹⁰ The latter are aimed at “mitigating systemic risk that can build up over the business cycle”.¹¹ As mentioned above, the former work by increasing costs while the latter imposes direct quantitative restrictions.

There are also broader macroprudential tools such as the “stress testing” programmes, which subject regulated entities to regular assessments based on standardised scenarios designed to test their resilience in the face of a variety of demanding economic contingencies. The ability of these institutions to withstand these stresses reinforces the stability of the financial system as a whole. Those that are found to be inadequate need to increase their capital and liquidity. In addition, there are a number of other actual and

⁹ José Viñals, ‘Making macroprudential policy work’, speech at the Brookings Institution, Washington D.C., 16th September 2013

¹⁰ Loretta Mester, ‘The nexus of macroprudential supervision, monetary policy and financial stability’, speech at the Federal Reserve Bank of Cleveland and the Office of Financial Research 2014 Financial Stability Conference, 5th December 2014

¹¹ Ibid, Mester. This is sometimes known as the “Kindleberger cycle” where “optimism over asset price rises [which] leads to lower credit standards in which the lender relies on asset price growth to absorb any credit defaults”

potential macroprudential tools. These include monetary policy, fiscal measures, in particular the use of taxation and the use of central bank facilities to provide liquidity to institutions and markets as the “lender of last resort”.¹² A number of Asian states have specifically combined macroprudential and fiscal measures to restrict the growth of credit. This raises important issues which are considered later in both this chapter and chapter 6. Finally, there is the employment of conduct of business regulation as a macroprudential tool. The latter is often over-looked as a macroprudential policy tool and its importance is a key theme in this thesis.

As discussed in the previous chapter, macroprudential tools can be widely defined to include a range of measures including stress testing, recovery and resolution planning, deposit protection insurance and the national and cross-border regulatory and supervision architecture as a whole. All of these help provide resilience to the financial system. There is a sweeping counter-argument which states, in a number of guises, that regulation, and in particular, deposit protection schemes, increase moral hazard because layers of safety-nets and protections encourage risk-taking and undermine prudence and caution.¹³ There is extensive literature discussing this issue which, however, falls outside the scope of this thesis.¹⁴

It is also worth taking a broader perspective when considering possible macroprudential tools. For example, it is likely that the search for higher returns during a period of low inflation and interest rates has encouraged financial institutions to innovate. This may undermine financial stability.¹⁵ It may be less costly for macroprudential policy if financial institution assets were “neutralised” by requiring a large proportion of them to be deposited

¹² Andrew Campbell and Rosa Lastra, ‘Revisiting the lender of last resort - the role of the Bank of England’, in Iain MacNeil and Justin O’Brien (eds) *The future of financial regulation*, (Hart, Oxford, 2010), 161-178, 163

¹³ Charles Calomiris and Stephen Haber, *Fragile by design*, (Princeton, New Jersey, 2014), 36-37 and 461-462, Andrew Campbell, “Designing a framework for protecting bank depositors”, in James Devenney, and Mel Kenny (eds), *Consumer credit, debt and investment in Europe*, (Cambridge University Press, 2012), 234-252, 234. See also Charles Goodhart, *The regulatory response to the financial crisis*, (Edward Elgar Publishing, Cheltenham, 2009), 42-44 who recognising the morale hazard risks but says that deposit protection needs to be balanced by heavy regulation

¹⁴ Ben Bernanke, *Essays on the Great Depression*, (Princeton, New Jersey, 2000) 89-97. See also Frederic Mishkin, *Prudential supervision: what works and what doesn't*, (University of Chicago Press, Chicago, 2001), 6-7; Chapt 2, n162, (Freixas, Laeven and Peydró), 37 and 112-113 and Franklin Allen, Elena Carletti and Agnese Leonello, ‘Deposit insurance and risk taking’, (2011) 27 (3) *Oxford Review of Economic Policy*, 464-478

¹⁵ Adair Turner, *The Turner review*, (Financial Services Authority, London, 2009), 47-49

at the central bank. This is a slightly less radical approach to those that advocate strict “narrow banking” where, for example, bank deposits can only be invested in government funds or deposited with the central bank.¹⁶ However, these restrictions have a history of being avoided.¹⁷ There are also measures adopted in Canada and Australia which require the insurance, often by government agencies, of higher risk mortgage lending.¹⁸ It has also been suggested that market forces could be harnessed by, for example, the Bank of England by increasing the liquidity requirements and paying higher rates of interest on bank reserve deposits and thus reducing the incentive for banks to develop new higher risk products.¹⁹ This is a very broad subject and, again, outside the scope of this thesis.

It has also been suggested that microprudential supervision can be dispensed with for individual financial organisations that are not systemically important and reliance placed wholly on macroprudential policy.²⁰ Individually, these smaller firms may not be able to damage financial stability but collectively, as a “herd”, they may threaten the stability of the system. Hence macroprudential policy can substitute for microprudential supervision of

¹⁶ Jaromir Benes and Michael Kumhof, ‘The ‘Chicago Plan’ revisited’, (2012) IMF Working Paper, WP/12/202, 4. This was a plan devised by Henry Simons of University of Chicago in 1930s and publicised by Irving Fisher of Yale in 1936. The plan would require “100% backing of deposits by government-issued money, and second” by ensuring that new bank credit was only financed by retained earnings. It would end fractional reserve banking since banks could only lend by borrowing money from the government. John Kay revived elements of this in *Narrow banking: the reform of banking regulation*, (2009, Centre for the Study of Financial Innovation, London). The subject is considered in Adair Turner’s, ‘Credit, money and leverage: what Wicksell, Hume and Fisher knew and modern macroeconomics forgot’, presentation at the Stockholm School of Economics conference, ‘Towards a sustainable financial system’, Stockholm, 12th September 2013

¹⁷ For example, prior to the financial crisis in 1907 in the US national banks had been heavily regulated and had to keep 25% of deposits in cash and gold and were prohibited from making loans secured on land. Trust organisations, however, had quickly developed and only had to keep 5% of deposits in cash and had no restrictions on lending. The US financial system came close to collapse when almost all the trusts failed - leading to the establishment of the Federal Reserve, Ellis Tallman and Jon Moen, ‘Lessons from the panic of 1907’, (May/June 1990) Economic Review, Federal Reserve Bank of Atlanta, 11-12. See also Larry Neal, ‘Trust companies and financial innovation, 1897-1914’, (Spring 1971) The Business History Review, Vol. 45, No. 1, 35, 37, describing the rapid rise of trusts out of the insurance industry into “shadow banks”, (page 39). See also Robert Bruner and Sean Carr, *The panic of 1907*, (John Wiley, London, 2007) Professor Bruner draws on his research as Dean of Darden School of Business, University of Virginia

¹⁸ Ivo Krznar and James Morsink, ‘With great power comes great responsibility: macroprudential tools at work in Canada’, (2014) IMF Working Paper 14/83, 15-16

¹⁹ Anil Kashyap and Jeremy Stein, ‘The optimal conduct of monetary policy with interest on reserves’, (2012) American Economic Journal: Macroeconomics 2012, 4(1): 266, 270

²⁰ Chapt 2, n97, (Brunnermeier), 28

these firms.²¹ As can be seen macroprudential policy and its operational tools can cover a very wide spectrum. The next section narrows the scope of these measures to those that seek to limit the growth of certain types of bank balance sheet assets.

This chapter has already mentioned the role of counter-cyclical capital and liquidity, since, in particular, the former has been the main macroprudential policy used in the UK to date. As already noted, capital and liquidity requirements are also the mainstays of microprudential regulation and supervision. They operate by raising the costs of financial institutions and hence reduce short-term profitability and returns to shareholders. The main focus is on tools which have curbing the growth of credit as their objective since, as mentioned, this is viewed as at the core of most financial crises and a cause of financial instability.²² It is worth noting that surges in the expansion of credit have also been blamed for the misallocation of national resources and high levels of inflation.²³ However, the main focus of the next sections will be on LTV and DTI measures which are perceived as exclusively macroprudential tools to control the growth of credit by limiting the quantity of the latter's use in financing property transactions.²⁴ These tools work best when operating "with the grain" of monetary policy and fiscal measures.²⁵

²¹ Note that there may be some rationality in such "herd" behaviour relevant to both macroprudential policy and microprudential supervision, Raghuram Rajan, 'Why bank credit policies fluctuate: a theory and some evidence', (1994) *The Quarterly Journal of Economics*, Vol. 109, No. 2, 399, 402

²² Chapt 2, n39, (Reinhart and Rogoff), xxv; Chapt 2, n58, (Kindleberger), 16; Atif Mian and Amir Sufi, *The house of debt*, (University of Chicago Press, Illinois, 2015), 75-91 and 65-66; Franklin Allen and Douglas Gale, *Understanding financial crises*, (Oxford University Press, Oxford, 2007), 237-238; Robert Shiller, *Irrational Exuberance*, (Princeton University Press, Princeton, New Jersey, 2015), 61-64; (Shiller goes further saying that from his survey of mortgagees in the US they saw their large debts as a means of buying properties larger than they could afford in order to take advantage of rising property prices in order to give themselves financial security in an unstable world, 61). See also Chapt 2, n71, (Aikman, Haldane, Nelson), 1

²³ Stacey Schreft, 'Credit controls: 1980', (November/December 1990) *Economic Review*, 26-27 considers the rationale for ending limits on war-time house purchase credit by Congress in 1953. See also Douglas Elliott, Greg Feldberg, and Andreas Lehnert, 'The history of cyclical macroprudential policy in the United States', (2013) Office of Financial Research Working Paper No. 8, Department of the Treasury, Washington DC, 13-16 references comments made by William McChesney Martin, to a 1952 Congressional hearing on the need to maintain "real estate credit regulations in this country aim[ed] principally at influencing the flow of particularly important, unstable, and pervasive tributaries of the general flow of credit" (page 13). The Credit Control Act 1969 did retain powers for the Federal Reserve Board to control access to credit but Nancy Teeters, Governor of the Federal Reserve Board of Governors, testified to a Congressional committee "that we have no intention of using [these powers] in circumstances short of a national war." (page 16)

²⁴ Andrew Haldane, 'Macroprudential policy in prospect' in George Akerlof, Olivier Blanchard, David Romer and Joseph Stiglitz (eds), *What have we learned?: macroprudential policy after the crisis*, (The MIT Press, Cambridge, Massachusetts, 2014), 67. See also Olivier Jeanne and Anton Korinek, 'Macroprudential Regulation Versus Mopping Up After the Crash', (2014), NBER Working Paper 18675

²⁵ Hyun Song Shin, 'Macroprudential policies beyond Basel III', (2010), Princeton University Policy Memo, 9-10

3.3 Relationship between macroprudential regulation and monetary policy

The Bank of England's Monetary Policy Committee (MPC) has price stability as its objective, while the primary objective of its Financial Policy Committee (FPC) is to protect and enhance the stability of the UK's financial system.²⁶ The relationship between the two committees was considered at a hearing of the Treasury Select Committee in January 2016.²⁷ The Governor of the Bank of England provided an insight into the interaction between the MPC and FPC. He explained that the FPC usually meets just before the MPC's meeting and the FPC agenda includes consideration of the "overall risk environment". This allowed the MPC to include the FPC's assessment in its own deliberations on monetary policy "recognising that monetary policy is viewed in general as the last line of defence against financial stability issues."²⁸ Fisher, who has served both on the MPC and FPC, has acknowledged that although each committee is independent this is only "partial" since what one committee does may affect the other.²⁹ He described this effect as "policy spillover".³⁰ He saw three factors as important as ensuring good coordination between the committees: cross-committee membership, shared information and a "common understanding of the economy."³¹ However, he was keen to stress that "coherence doesn't always mean agreement" and it is important that dissent is part of the culture of both committees.³²

²⁶ The Bank of England was given its financial stability objective under 2 (2) (a) of the Financial Services Act 2012 and the same legislation established the FPC and its objectives (9C (1) (a)). Philip Rawlings, 'All change: the fall of the FSA and the further rise of the Bank of England', (2011) 30 (4) U.S. Banking & Financial Services Policy Report 16, 20, recognising the connection between monetary policy and financial stability

²⁷ Oral evidence: Bank of England December 2015 Financial Stability Report, HC 780, 26th January 2016. This is supported by Frank Smets, 'Financial stability and monetary policy: how closely interlinked?', (2014) International Journal of Central Banking, Vol. 10(2), 262, 291-292

²⁸ Ibid, (oral evidence) answer to question 104

²⁹ Paul Fisher, 'Microprudential, macroprudential and monetary policy: conflict, compromise or co-ordination?', speech at Richmond University, London, 1st October 2014, 5

³⁰ Ibid, 5

³¹ Ibid, 6

³² Ibid, 10, See also Bianca De Paoli and Matthias Paustian, 'Coordinating monetary and macroprudential policies', (2013) Federal Reserve Bank of New York Staff Reports No. 653, which proposes an over-complex process to ensure coordination

The MPC may maintain low interest rates in order to meet its objectives. However, the FPC will take action to “ensure that a tail of highly indebted households does not emerge as a result of this ... That is a fundamental point about the difference between macroprudential policy and monetary policy. Monetary policy is [about] delivering averages. Macroprudential policy is about taking out the tail risks.”³³ Alex Brazier, Executive Director, Financial Stability Strategy and Risk at the Bank of England, gave, as an example, the action taken by the FPC in 2014 to limit high loan to value lending. “In the owner-occupied housing market ... the action we took then was to prevent a tail of highly indebted households from emerging. At the time, we did not think that that action would bite, because the threshold we set for the proportion of mortgages that could be at high loan to income ratios was in excess of what was actually going on. It was an insurance policy against a risk building...it looked like it may have been contradictory with what the MPC was trying to achieve at that point, but in no sense was it contradictory. It actually helped the MPC to sustain the monetary policy stance”.³⁴

Clearly, Macroprudential policymakers are aware that they need to work closely with those responsible for both microprudential and monetary policy.³⁵ However, macroprudential policy cannot be successfully used to remedy issues with monetary policy where, for example, the latter is constrained by a currency union or where monetary policy lacks credibility.³⁶ There is evidence that loose monetary policy encourages less attention to

³³ Supra note 27, (Oral evidence, 26th January 2016). See also the answer to question 139 by Brazier, “Let us suppose we wanted to think about the housing market....You can look at rental yields, for example. You may take some comfort from the fact that rental yields... in most areas of the country, look in line with long-running averages. If you were trying to spot the central outlook for the cycle, [you are also looking at whether] yields are lower now than they were, on average, in the past. On that basis, your view of the tail event [c]ould be bigger than it was in the past. We are not just trying to assess how things look upon the face of it today. We are trying to ask the question: how bad could it be? That is where we use our risk appetite and why we try to specify what could happen. The most interesting thing I heard a senior policymaker say about the financial crisiswas that we spent far too long thinking about whether there was a housing bubble and not enough time thinking about what if there is a housing bubble”

³⁴ Ibid, answer to question 118

³⁵ Donald Kohn, ‘Comparing UK and US macroprudential systems: lessons for China’, speech at the Global Financial Forum, Tsinghua University, Beijing, 11th May 2014, 5-6. See also Jaime Caruana, ‘Macroprudential policy: working towards a new consensus’, remarks at a high-level meeting of BIS and the IMF on ‘The emerging framework for financial regulation and monetary policy’, 23rd April 2010. He saw “taxes/levies and capital surcharges are complements” but in emphasising the importance of capital he relegates levies and taxes to “dealing with an externality and promot[ing] burden-sharing”. (page 5)

³⁶ IMF, ‘The interaction of monetary and macroprudential policies’, (29th January 2013), 17 and 18

credit quality assessments by lenders.³⁷ Alan Greenspan's remarked that "this vast increase in the market value of asset claims is in part the indirect result of investors accepting lower compensation for risk. Such an increase in market value is too often viewed by market participants as structural and permanent...But what they perceive as newly abundant liquidity can readily disappear...history has not dealt kindly with the aftermath of protracted periods of low risk premiums."³⁸ However, it is hard to identify asset mis-pricing in time.³⁹

Monetary policy can be used to deliver financial stability by increasing the cost of borrowing and reducing the value of assets that could be used as collateral for increased credit.⁴⁰ Consequently, higher interest rates tend to reduce the growth of financial intermediaries' balance sheets that often facilitate credit growth.⁴¹ There is a trade-off between perceptions of asset value increases and risk, and on the other hand, the threats to lender liquidity - since asset financing is often based on short-term funding.⁴² The effect is particularly strong depending on the level of liquidity weakness in the balance sheet.

³⁷ Chapt 2, n11, (Jimenez and Saurina), 94. See also Daniel Foos, Lars Norden, Martin Weber, 'Loan growth and riskiness of banks', (2010) Journal of Banking and Finance, Vol. 34, Issue 12, 2929. There are similar findings in the Eurozone, Angela Maddaloni and José-Luis Peydró, 'The low monetary rates paradox, banking stability and credit: evidence from the Euro-area', (2013) International Journal of Central Banking, Vol. 9, No.1, 121, 122. See also Sylvain Leduc and Jean-Marc Natal, 'Monetary and macroprudential policy in a leveraged economy', (2015) Federal Reserve Bank of San Francisco Working Paper Series, who provide an economic underpinning for this latter view and Adam Klaus and Michael Woodford, 'Housing prices and robustly optimal monetary policy', (2013) Working Paper, argue that house price inflation should form part of the prices measure for monetary policy

³⁸ Chapt 2, n112, (Greenspan, "*Reflections on central banking*")

³⁹ Jonathan McCarthy and Richard Peach, 'Are home prices the next "bubble"?', (2004) Economic Policy Review, New York Federal Reserve Board, Vol. 10, No. 3

⁴⁰ Ben Bernanke and Mark Gertler, 'Inside the black box: the credit channel of monetary policy transmission', (1995) Journal of Economic Perspectives Vol. 9 No. 4, 27, 35-44. One of the oddities about macroeconomic theory is that the standard model: dynamic stochastic general equilibrium (DSGE) is "inherently non-monetary. Since there are by construction no banks, no borrowing constraints and no risks of default, the risk free short-term interest rate suffices to model the monetary side of the economy. As a consequence, money or credit aggregates and asset prices play no role in standard versions of these models." Charles Goodhart and Boris Hofmann, 'House prices, money, credit and the macroeconomy', (2008) European Central Bank Working Paper Series No.888, 6

⁴¹ Tobias Adrian and Hyun Song Shin, 'Financial intermediaries and monetary economics', (2009) Federal Reserve Bank of New York Staff Reports, No. 398, 64-65

⁴² Chapt 2, n11, (Borio and Zhu, 'Capital regulation'), 19. See chapt 2, n140, (Goodhart, Tsomocos and Shubik), 28, and Charles Goodhart and Dimitrios Tsomocos, 'Analysis of financial stability', (2007) LSE Financial Markets Group Special Paper 173, 19

It also has an immediate effect on financial institutions that watch their net interest margin (NIM) closely since these are likely to contract. Those lenders, however, betting on asset price rises may be impervious to NIM reductions. Contractions in the money supply will also reduce deposits which transmits itself through to a reduction in assets. However, there is a time-lag of several months before these effects can be seen and bank balance sheets restabilise. This process may lead to a period of financial instability as banks become forced sellers of securities as they deleverage.⁴³ Monetary policy thus affects both sides of the lenders' balance sheet. The effect can produce a sudden shock to the financial system with implications for financial stability.⁴⁴ However, it is worth noting that much depends on the institutions' perception of the risks and whether they actually perceived, for example, triple A rated collateralised debt obligations as high risk. "It is important to bear in mind that this behavior of banks is not irrational; simply they live in the same economic environment" as everyone else with which they share the "expectational climate...euphoric expectations pushing firms to expand their business during booms is the same optimism motivating banks to expand credit."⁴⁵

Finally, there is a view that excessive central bank independence with its unrelenting focus on monetary policy can induce financial instability.⁴⁶ This may be due to a number of factors including being isolated from political factors which may require a more balanced approach and the "creation of paradox of credibility" in which the belief permeates the market that the central bank will prevent financial problems.⁴⁷

Further, financial stability and monetary policy concerns may not coincide so, for example, an increase in interest rates may damage the broader economy when a looser macroeconomic policy was more appropriate. This clearly would have social and political

⁴³ Ben Bernanke and Alan Blinder, 'The Federal Funds Rate and the channels of monetary transmission', (1992) *The American Economic Review* Vol. 82 No. 4, 901, 919

⁴⁴ Chapt 2, n11, Borió and Zhu ('Capital regulation'), 17-18. See also Gianni De Nicolò and others, 'Monetary policy and bank risk taking', (2010) IMF Staff Position Note, SPN/10/09, 12-13, which supports the view that loose monetary policy increases risk as financial firms search for yield and incur higher asset risks

⁴⁵ Eugenio Caverzasi, 'Minsky and the subprime mortgage crisis: the financial instability hypothesis in the era of financialization', (2014) Levy Economics Institute, Bard College, Working Paper No. 796, 14

⁴⁶ Wolfram Berger and Friedrich Kissmer, 'Central bank independence and financial stability: A tale of perfect harmony?', (2013) *European Journal of Political Economy*, Vol. 31, 109, 110

⁴⁷ Michael Bordo, 'Central bank independence and financial crises in history', (2010) Oesterreichische 38th Economics Conference 2010, 33-34, and Martin Čihák, 'Price stability, financial stability, and central bank independence', (ibid, 50)

implications.⁴⁸ In addition, increased rates would increase the debt burden of financial services firms and weaken their asset base which could have the effect of increasing financial instability.⁴⁹ It also appears that investors may be impervious to higher interest rates in the short term if they remain convinced that asset prices will continue to rise since the benefits of the latter may substantially out-weigh the immediate higher interest rate costs.⁵⁰ There will also a time-lag before higher interest rates becoming effective and it is possible that the credit boom may continue to expand for some time before the effect of the new borrowing costs are felt and financial instability increases in this interim period.⁵¹ This suggests that the use of monetary and macroprudential policies may be complementary with the former used, for example, if there is evidence of serious avoidance of the macroprudential tools employed.⁵² Consequently, the better view may be that while monetary policy may be used as a last resort to protect financial stability there are more appropriate macroprudential tools available.⁵³

Not all credit is of equal concern. The evidence suggests that different categories of credit are extended in the run-up to a financial crisis.⁵⁴ These can be divided into those which are considered “sound” in all circumstances, for example, lending to prime quality borrowers at LTVs of 70% or less and those mortgages which are provided to high-risk borrowers at high LTVs. The latter is speculative and depends on good economic conditions and rising property prices. It is unlikely that this latter type of lending will “be

⁴⁸ Giovanni Dell'Ariccia, and others, ‘Policies for macrofinancial stability: how to deal with credit booms’, (2012), IMF Staff Discussion Note, No.12/06, 19-22. See also Luisa Lambertini, Caterina Mendicino and Maria Teresa Punz, ‘Leaning against boom-bust cycles in credit and housing prices’, (2011) Banco de Portugal Working Papers 8/2011, 16

⁴⁹ Paolo Gelain, Kevin Lansing and Gisle Natvik, ‘Leaning against the credit cycle’, (2015) Norges Bank Research Working Paper, 04/2015, 19

⁵⁰ Giovanni Dell'Ariccia, Deniz Igan and Luc Laevan, ‘Credit booms and lending standards: evidence from the subprime mortgage market’, (2012) Journal of Money, Credit and Banking, Vol. 44, Issue 2-3, 367, 377. See also IMF Staff Report, ‘Monetary policy and financial stability’, (September 2015), 29, views the “transmission from interest rates to financial risk [as] weak”, costs appear higher than benefits and keeping monetary policy focused on price stability simplifies “communication and enhances accountability”

⁵¹ Supra, note 43, (Bernanke and Blinder), 919. See also European Central Bank, ‘Report on the first two years of the macroprudential research network’, (2012), 32 and the ECB’s, ‘Final report’, (2014)

⁵² Chapt 2, n11, (Brunnermeier and Schnabel), 21-22

⁵³ Daniel Tarullo, ‘Monetary policy and financial stability’, speech at the 30th Annual National Association for Business Economics Economic Policy Conference, Arlington, Virginia, 25th February 2014

⁵⁴ Chapt 2, n34, (Crowe ‘Policies’), 12

stemmed by changes in the monetary policy stance.”⁵⁵ This tends to negate the use of monetary policy for macroprudential purposes.

There is also a view that interest rates are too blunt an instrument to be used to address instability risks.⁵⁶ Nevertheless, Stein’s view is that financial stability concerns should influence monetary policy decisions since the consequences of financial instability are likely to undermine monetary policy objectives if they are not addressed.⁵⁷ However, diluting clear targets for monetary policy with other objectives could undermine its effectiveness and threaten the creditability of an independent central bank.⁵⁸

Monetary and financial stability policies have different objectives. “They are best conducted separately” even if the same authority is in charge of both.⁵⁹ “Price stability does not imply financial stability” and vice versa.⁶⁰ However, a failure to ensure financial stability is likely

⁵⁵ Chapt 2, n34, (Crowe), 12

⁵⁶ A. J. Hughes Hallett, ‘Econometrics and the theory of economic policy: the Tinbergen–Theil contributions 40 years on’, (1989) Oxford Economic Papers, New Series, Vol. 41, No. 1, History and Methodology of Econometrics, 189. See also, Adam Posen, ‘Do we know what we need to know in order to lean against the wind?’, speech at the Cato Institute 28th Annual Monetary Conference, Washington DC on ‘Is monetary policy responsible for bubbles?’, 18th November 2010, Michael Woodford, ‘Inflation targeting and financial stability’, (2012), NBER Working Paper No. 17967, 24, argues that inflation targeting can be adjusted to take account of the need to protect financial stability. This is supported by Leonardo Gambacorta and Federico Signoretti, ‘Should monetary policy lean against the wind?’, (2013) BIS Working Papers No 418, 2

⁵⁷ Jeremy Stein, ‘Incorporating financial stability considerations into a monetary policy framework’, speech at the International Research Forum on Monetary Policy, Washington, D.C., 21st March 2014

⁵⁸ John Williams, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, ‘Macroprudential policy in a microprudential world’, (June 2015) Federal Reserve Board of San Francisco Economic Letter, 2015-18, 2. John Taylor and John Williams, ‘Simple and robust rules for monetary policy’, (2010), Federal Reserve Bank of San Francisco Working Paper Series 2010-10, 36, who make a similar point in relation to monetary policy makes a similar point and stating, for example, that the introduction of pro-cyclical capital buffers would probably have been mis-judged and mis-timed

⁵⁹ Lars Svensson, ‘Monetary policy and financial stability’, speech at ‘Financial liberalization, innovation, and stability: international experience and relevance for China’, the 3rd Joint Conference, People’s Bank of China and IMF, Beijing, 16th March 2015. Narayana Kocherlakota considers that the Federal Reserve Board] will only achieve its dual mandates at the cost of financial instability, ‘Low real interest rates’, speech at the Ninth Annual Finance Conference, Carroll School of Management, Boston College, Boston, Massachusetts, 5th June 2014. See also Pierre-Richard Agénor, Koray Alper, and Luiz Pereira da Silva, ‘Capital regulation, monetary policy, and financial stability’, (September 2013) International Journal of Central Banking, 193, 198, in which the authors suggest that in periods of low interests macroprudential policy is needed to reduce the growth of credit

⁶⁰ Ibid, (Svensson), 4

to undermine a central bank's price stability strategy.⁶¹ "As Minsky demonstrated, price stability may even conflict with financial stability, rather than complement it. This is because a reduction in macroeconomic volatility may seem to reduce risk, and therefore make financial institutions raise their leverage, and reach for yield."⁶² Similar arguments apply to low inflation. During periods of continuing and expected low inflation, lenders are protected by monetary policy and with little or no risk of inflation are inclined to lend more.⁶³ Monetary policy does not target the key imbalances and "involves too much collateral damage to activity."⁶⁴ "Macroprudential instruments seem more appropriate which focused more directly on the source of the excessive exuberance. But we still have much to learn about how such instruments work in practice and how they interface with monetary policy."⁶⁵ In addition, while interest rate changes may moderate the business cycle there is no evidence that they affect the credit cycle.⁶⁶

The problem is highlighted when there is a lack of clarity over the role of the macroprudential regulator. In recent years this is evident in Sweden. The central Riksbank is responsible for monetary policy. However, it has expressed considerable concern that the macroprudential and microprudential regulator, Finansinspektionen, has failed to control indebtedness and other areas of macroprudential policy.⁶⁷ Consequently, the Riksbank has kept interest rates higher than they should be with consequences for

⁶¹ Andrew Levin, 'The design and communication of systematic monetary policy strategies', (2014), 13, Hoover Institution conference on 'Frameworks for central banking in the next century', at Stanford University, 29th and 30th May 2014

⁶² Chapt 2, n119, (Goodhart, 'Lessons for monetary policy'), 3

⁶³ Evan Koenig, 'Like a good neighbor: monetary policy, financial stability, and the distribution of risk', (2013) International Journal of Central Banking, 9, 57, 57-59

⁶⁴ Charles Bean and others, 'Monetary policy after the fall', Federal Reserve Bank of Kansas City Annual Conference Jackson Hole, Wyoming, 16th September 2010, 28

⁶⁵ Ibid, 28

⁶⁶ Chapt 2, n71, (Aikman, Haldane, Nelson), 27. See also Janet Yellen, "it is also clear that a tighter monetary policy would have been a very blunt tool If monetary policy is not to play a central role in addressing financial stability issues, this task must rely on macroprudential policies." 'Monetary policy and financial stability', at the Michel Camdessus Central Banking Lecture, IMF, Washington, D.C., 2nd July 2014

⁶⁷ Sveriges Riksbank, 'Further measures are needed to manage household indebtedness', (Press release), 25th November 2015). See also Sveriges Riksbank's 'Financial stability report' (2015:1), 17-33

employment and growth.⁶⁸ This approach is sometimes described as “leaning against the wind” where monetary policy is used to set a higher interest rate than would be justified simply to meet the inflation target. The consequential adverse effect on the economy and employment is balanced against the threat to financial stability.⁶⁹ “Monetary policy ...can be one of several factors contributing to a build-up of financial imbalances... long periods of low interest rates can increase the risk that debt and asset prices will reach unsustainable levels...low interest rates tend to prompt financial market participants to intensify their search for yields from high-risk assets. Hence, even though the objectives and the instruments are different, monetary policy and macroprudential policy cannot be viewed as separate.”⁷⁰

However, there are strong arguments for what has been described as a “decoupling approach” with monetary policy solely targeted at price stability while macroprudential policy is used to ensure financial stability.⁷¹ Therefore, there is a stronger case for employing monetary policy alongside other regulatory actions since the former “may reach into corners of the market that supervision and regulation cannot.”⁷² It remains uncertain which macroprudential tools are effective and how best they should be used. These issues are considered later in this chapter. Nevertheless, the evidence is that interest rates will

⁶⁸ John Williams, ‘Financial stability and monetary policy: happy marriage or untenable union?’, (June 2014), Federal Reserve Board of San Francisco Economic Letter, 2014-17, “In a nutshell, the Sveriges Riksbank has undertaken a somewhat tighter stance of monetary policy than it would were it based purely on macroeconomic conditions”. However, it is worth noting that, contrary to expectations, a monetary policy increase in interests rates during an asset price bubble may not necessarily result in a decrease in asset prices, Jordi Galí, ‘Monetary policy and rational asset price bubbles’, (2014) American Economic Review 104, 721, 722

⁶⁹ Lars Svensson, ‘Cost benefit analysis of leaning against the wind: are costs larger also with less effective macroprudential policy?’, (2016) IMF Working Paper, WP/16/3. See also Karen Harris, ‘Anticipatory regulation for management of banking crises’, (2005) 38 Columbia Journal of Law and Social Problems 251, 285

⁷⁰ Øystein Olsen, ‘Integrating financial stability and monetary policy analysis’, speech at the London School of Economics and Political Science, 27th April 2015. The problems of using monetary policy have been described as “disruptive monetary policy spillovers”, Bank of International Settlements, ‘84th Annual Report’, (2014), 96

⁷¹ Jeremy Stein, ‘Overheating in the credit market: origins, measurement and policy response’, (2013), paper presented to a research symposium sponsored by the Federal Reserve Board of St Louis, 15

⁷² Ibid, 17 and Claudio Borió and Mathias Drehmann, ‘Financial instability and macroeconomics: bridging the gulf’, (2009), paper presented at the Twelfth Annual International Banking Conference, ‘The international financial crisis: have the rules of finance changed?’, held at the Federal Reserve Bank of Chicago, Chicago, Both Borió and Drehmann stress that monetary policy cannot, however, be relied upon on its own but needs to be supported by macroprudential policy. See also Janet Yellen, ‘A Minsky meltdown: lessons for central bankers’, a presentation to the 18th annual Hyman Minsky Conference on the State of the U.S. and World Economies, ‘Meeting the Challenges of the Financial Crisis’, 16th April 2009, 14

“influence house prices, leverage, and maturity transformation”, but it may be appropriate to adjust monetary policy to “get in the cracks” that persist in the macroprudential framework.”⁷³ In addition, there are many traditional monetary policy tools such as banking reserve requirements which can also be used as macroprudential tools.”⁷⁴ Nevertheless, it may be “helpful to distinguish between tools that primarily build through-the-cycle resilience against adverse financial developments and those primarily intended to lean against financial excesses.”⁷⁵

In conclusion, the proposition can be summarised by stating that “[a] robust monetary policy should ...take into account the risk of a build-up of financial imbalances....At the same time, monetary policy must not be overburdened. Banking regulation and supervision must be the first line of defence against shocks to the financial system.”⁷⁶ Indeed, there are limits to both monetary and macroprudential policies and there may be market changes that cannot be detected and regulatory action may be too slow.⁷⁷ Nevertheless, it is likely that monetary policy actions may be responsible, at least in part, for some of the financial imbalances which threaten financial stability.⁷⁸ Low interest rates may encourage increased demand for credit and, at the same time, encourage a search by savers for yield and consequently greater risk.⁷⁹ Moreover, it is likely that it is “new” debt that may be destabilising and an increase in interest rates affects all debt and not just the issue of rapid credit expansion.⁸⁰ Consequently, using monetary policy to address macroprudential concerns may result in some new cracks being opened. Nevertheless, macroprudential policy cannot “substitute for monetary policy” and, as this thesis

⁷³ Andrea Ajello and others, ‘Financial stability and optimal interest-rate policy’, (2015), Board of Governors of the Federal Reserve, Working Paper

⁷⁴ Stanley Fischer, (Vice-chairman of the Federal Reserve Board), ‘Macroprudential monetary policy’, speech at the 59th Economic Conference of the Federal Reserve Bank of Boston, Boston, Massachusetts, 2nd October 2015

⁷⁵ Supra, note 66, (Yellen, ‘Monetary policy and financial stability’, 2nd July 2014)

⁷⁶ Ibid, (Øystein Olsen, ‘Integrating financial stability and monetary policy Analysis’)

⁷⁷ Ibid, 16-17

⁷⁸ “I am also mindful of the potential for low interest rates to heighten the incentives of financial market participants to reach for yield and take on risk, and of the limits of macroprudential measures to address these and other financial stability concerns.” Supra, note 66 Janet Yellen, ‘Monetary policy and financial stability’

⁷⁹ Chapt 2, n71, (Aikman, Haldane and Nelson)

⁸⁰ Supra note 49, (Gelain, Lansing, and Natvik), 19

discusses, “the politics...are much more complicated than the politics of monetary policy”.⁸¹

Therefore, it is important to consider other tools first and the next section considers whether fiscal policy may provide better options for macroprudential policy.

3.4 Fiscal Policy

Discussion has been limited on the role of fiscal levers in achieving macroprudential objectives. Fiscal policies may affect the two main aspects of microprudential policy: those actions that influence the cost structures of banks (eg requiring more and specific types of capital) and those that control the quantity and type of business.⁸² There is a microprudential policy preference towards using the former since they leave the associated problems with the bank and are less overt than direct restrictions. How banks meet their capital requirements is likely to be strongly influenced by fiscal policy since taxation policies increase the propensity of banks to hold debt capital rather than equity and that this in turn increases credit growth.⁸³ However, there is no evidence that taxation policies were a direct factor in causing the recent financial crisis.⁸⁴

There are a range of fiscal measures that could be used as part of a macroprudential policy to contain or restrict the growth of credit. These include restricting the deductibility of long-term debt interest from profits.⁸⁵ This would have the effect of increasing the cost of

⁸¹ Philipp Hildebrand, former head of the Swiss Central Bank, quoted in the Financial Times, ‘*Bank of England: crashing the party*’, (24th June 2014)

⁸² Beatrice Weder di Mauro and Ulrich Klüh, ‘Reshaping systemic risk regulation in Europe’ in Stijn Claessens, Michael Keen, and Ceyla Pazarbasioglu (eds), ‘*Financial sector taxation: The IMF’s report to the G-20*’, (2010), 90

⁸³ Ruud de Mooij, Michael Keen, and Masanori Orihara, ‘Taxation, bank leverage, and financial crises’, (2013) IMF Working Paper. This paper provides evidence that “debt bias” in taxation policy increases bank leverage which in turn makes a financial crisis more likely and, consequently, implies a “welfare gains from mitigating debt bias”. (page 20)

⁸⁴ Julian Alworth and Giampaolo Arachi, *Taxation and the financial crisis*, (Julian Alworth and Giampaolo Arachi (eds), Oxford University Press, Oxford, 2012), 26

⁸⁵ This could be achieved by introducing an “Allowance for Corporate Equity” (ACE) which would allow a cost of equity deduction from corporation tax so that the cost of equity equated to that for debt capital. This can be contrasted with a “Comprehensive Business Income Tax” (CBIT) which taxes revenue with no deduction for the cost of capital, ‘Written evidence submitted by Professor Michael Devereux and Dr. John Vella to the Parliamentary Commission for Banking Standards’, 24th June 2013

bank capital and probably result in deleveraging assets.⁸⁶ There are proposals which differentiate between different sources of bank profits with high rates of taxation applied to profits from more risky activities.⁸⁷ One proposal is to levy a “Pigouvian tax” on bank lending to reduce the level of such lending and to reflect the externalities if subsequent problems with such bank assets results in public assistance to banks and to help reinflate the economy.⁸⁸ In addition, there are the straight-forward imposition of bank levies based on balance sheets and, separately, transaction taxes.⁸⁹ An annual bank levy has been imposed on large UK banks since the financial crisis. However, research indicates that in response the more risky banks further increase their portfolio risk.⁹⁰

There is also evidence that fiscal measures may be ineffective in preventing or containing an economic boom due to the time it takes for them to become effective.⁹¹ There is the additional issue that fiscal “tools” are prone to political interference since they are a key element of most government policies. Moreover, as already mentioned, there are sufficient difficulties in coordinating monetary and macroprudential policies and it is even more difficult to do this when it comes to influencing government spending and taxation

⁸⁶ John Cochrane, ‘Equity-financed banking and a run-free financial system’, comments given at the ‘Ending too big to fail symposium’, Federal Reserve Bank of Minneapolis, 16th May 2016, 8. Cochrane considered that “capital regulation should ...take the form of Pigouvian taxes rather than a regulatory ratio. For every dollar of short-term debt that a bank or other intermediary issues, it has to pay ...five cents tax per year. That tax could ... decline smoothly with maturity, be larger depending on capital ratios and other measures of how run-prone the institution is [and] be larger for "systemically important" institutions, and could be varied over time as macroprudential policymakers sniff trouble”

⁸⁷ Andrew Mullineux, ‘Taxing banks fairly’, (2012) *International Review of Financial Analysis* 25, 154, 157-158

⁸⁸ Olivier Jeanne and Anton Korinek, ‘Managing credit booms and busts: a Pigouvian taxation approach’, (2010) National Bureau of Economics Research Working Paper No. 16377. The tax would reflect the costs of the business operation which are not internalised by the business and reflected in its costs, Arthur Pigou, *The economics of welfare*, (published 1920, McMillan, London, 1932), 138. See also ‘Financial sector taxation: the IMF’s report to the G-20’, (Stijn Claessens, Michael Keen, and Ceyla Pazarbasioglu (eds) 2010). This report is largely focused on financial transaction taxation but it also includes sections on using taxation as primarily a microprudential tool with macroprudential benefits. For example, a tax could be levied on short-term wholesale funding to encourage banks to issue medium and long-term debt (page 50). There is a similar proposal by Javier Bianchi and Enrique Mendoza, ‘Overborrowing, financial crises and ‘macroprudential’ policy’, (2011), IMF Working Paper WP/11/24, 45

⁸⁹ Michael Devereux, John Vella and Niels Johannesen, ‘Can taxes tame the banks? Evidence from European bank levies’, (2013) Oxford University Centre for Business Taxation, WP 13/25. See also Hyun Song Shin, ‘Non-core liabilities tax as a tool for prudential regulation’, (2010) Policy Note, which proposes a tax on liabilities other than equity, money markets and customer deposits as a method of restraining bank growth

⁹⁰ Ibid, (Devereux, Vella and Johannesen), 23

⁹¹ Ibid, (Devereux, Vella and Johannesen), 22

strategies. However, it is interesting to note the actions taken by both the FPC and HM Treasury to restrict buy-to-let lending. The latter employed fiscal measures, increased stamp duty land tax (SDLT) and limited the set-off of mortgage interest against rental income thus reducing the attractiveness of this market.⁹²

Nevertheless, it is important to consider the effectiveness of existing financial stability protection measures and the next section explores the use of microprudential capital and liquidity tools used for macroprudential purposes.

3.5 Macroprudential and microprudential policies

It is possible to view macroprudential measures as microprudential policies writ large. In many ways macroprudential policy is an adjunct to microprudential regulation since they both use similar tools and a microprudential regulator would not be doing their job properly if they failed to “look at the big picture.”⁹³ It is also possible to view risk as divided between that which is idiosyncratic and that which is subject to microprudential policy and, separately, market risk which falls to macroprudential oversight.⁹⁴ Further, the distinction between macro and microprudential policy gets blurred if the banking system is highly concentrated in the hands of a few large banks.⁹⁵ However, from my own experience, there is a rational tendency for microprudential regulators to try to place a boundary around their areas of responsibility to ensure focus and to best employ their finite resources. The microprudential regulator will attempt to avoid issues posed by “the turbulent frontier” where there is always pressure to attempt to regulate one further aspect or type of business.⁹⁶ This issue is discussed in more detail in the next section. It presents a significant risk to the microprudential regulator since resources and senior management

⁹² See the Chancellor of the Exchequer’s Parliamentary Budget speech on 16th March 2016. SDLT increases to 15% of the value of the properties over £1.5m if bought as a buy-to-let investment or second home compared to 12% for a main residence

⁹³ Chapt 2, n152, (Ellis, ‘Macroprudential policy: a suite of tools or a state of mind’) See also Joseph Stiglitz, ‘Lessons from the North Atlantic crisis for economic theory and policy’, in George Akerlof, Olivier Blanchard, David Romer and Joseph Stiglitz (eds), *What have we learned?: macroprudential policy after the crisis*, (MIT Press, Cambridge, Massachusetts, 2014), 342-343

⁹⁴ Malcolm Edey (Assistant Governor (Financial System) of the Reserve Bank of Australia), ‘Macroprudential supervision and the role of central banks’, remarks to the Regional Policy Forum on Financial Stability and Macroprudential Supervision, Beijing, 28th September 2012

⁹⁵ Chapt 2, n152, (Ellis, ‘What have we learned?’), 5

⁹⁶ Chapt 2, n16, (Galbraith, ‘The “turbulent frontier” as a factor in British expansion’), 150

focus are likely to be dissipated and in an attempt to control every area nothing is properly supervised. The result is that macroprudential policy needs to look over the horizon and must not be constrained by artificial regulatory boundaries.

Consequently, macroprudential policy can best be described more as “a state of mind than a suite of tools.”⁹⁷ In part, macroprudential policy “creep” is a consequence of the migration of risk to new areas, either to avoid regulatory attention or simply due to market dynamics. The difference between micro and macroprudential policy is highlighted by the different questions asked. The microprudential supervisor may only ask if there is, for example, rapid growth in credit in the regulated institutions while macroprudential regulation needs to ask the broader question: where is credit growing? This could relate to a particular market or group of institutions. As discussed later in this chapter it is this breath of view which harbours both the strengths and weaknesses of macroprudential policy.

The overlap in responsibilities and available tools may lead to tensions between macro and microprudential policies.⁹⁸ There are also strong cultural differences. The microprudential supervisor will be immersed in the detail of the institutions they supervise. They will have to be experts in the latest technical guidance and will need to consider issues posed by institutions attempting to interpret and implement the latest rules and other requirements. At any point in time they will be preparing for, or undertaking, a review of particular aspects of an institution and they will be caught up with the bureaucracy of regulation and supervision (eg preparing briefings, contributing to reports, providing daily, weekly and monthly progress information etc) and undertaking training and attending many coordination meetings. Microprudential policy considers not just the capital and liquidity and the financial numbers but also the institution’s business plan and the “human element” since the culture and ethos generated by the board and senior management of a financial services firm may have a “profound effect” on the business and its operations.⁹⁹ All the time the microprudential supervisors will be attempting to avoid being “captured” by the regulated institutions or, at the other extreme, be corrupted by the exercise of power. Consequently, it is very difficult for the microprudential supervisor to take a broad

⁹⁷ Chapt 2, n152, (Ellis, ‘What have we learnt?’) 8th paragraph

⁹⁸ Supra, note 4, (Osiński, Seal, and Hoogduin), 6-9

⁹⁹ Katherine Braddick (Director of Prudential Policy at the Prudential Regulatory Authority), ‘The changing face of prudential policy’, speech at the Future of Financial Services Summit, London, 11th March 2014)

perspective. Organisationally, the institution responsible for microprudential policy may seek to avoid this difficulty by having dedicated units responsible for key microprudential ‘themes’ which affect a number of supervised institutions. However, at its heart, microprudential policy remains concerned with the safety and soundness of individual firms.

Macroprudential policy, as discussed in the previous chapter, knows almost no boundaries. It must consider the areas beyond the regulatory perimeter both domestically and internationally. It will be concerned with government policies and their implications, the role and development of markets, demographics, technology, climate change etc.¹⁰⁰ It is possible that with this breadth to their scope macroprudential and microprudential policy may become uncoordinated particularly in view of their very different time horizons. Microprudential supervision may appear to lack perspective while macroprudential policy may be seen as too esoteric. The Bank of England has expressed concern that it “still has a long way to go to integrate micro and macroprudential” policies.¹⁰¹

There has been limited use of quantitative limits on credit creation as a macroprudential tool and the next section considers LTV and DTI restrictions on debt and the issues with their use and their effectiveness.

3.6 Loan to Value (LTV) and Debt to Income (DTI) tools: how they work and issues with their use

There is still a lack of knowledge of how macroprudential tools generally work in practice.¹⁰² However, there is some evidence from other jurisdictions on the use of LTV

¹⁰⁰ For example, Mark Carney, ‘Breaking the tragedy of the horizon - climate change and financial stability’, speech at Lloyd’s of London, 29th September 2015). See also Mark Carney’s letter of 8th July 2014 to the Parliamentary Environmental Audit Committee and the minutes from the Financial Policy Committee meeting of 24th March 2015, 8, on climate change risk to financial stability

¹⁰¹ Andrew Bailey’s speech at the New York Federal Reserve Board conference on ‘defining the objectives and goals of supervision’, 18th March 2016

¹⁰² Many writers on macroprudential policy focus exclusively on those tools that raise bank costs and to ignore those that are quantitative in nature. For example, Tobias Adrian, Daniel Covitz and Nellie Liang, ‘Financial stability monitoring’, (2014) Federal Reserve Bank of New York Staff Reports No. 601. At the other extreme there is a risk of macroprudential policy limiting itself only to LTV measures, (eg Sami Alpanda and Sarah Zubairy, ‘Addressing household indebtedness: monetary, fiscal and macroprudential policy?’, (2014) Bank of Canada Working Paper 2014-58, 24-26)

and DTI measures and these are discussed later in this chapter. The power to employ these measures was granted to the FPC in 2015.¹⁰³

The use of quantitative restrictions such as those on LTVs and DTI may have a number of advantages over those macroprudential tools which try to increase the cost of capital and lower lender margins. For example, if capital and liquidity are freely available due to, for example, capital inflows, then quantitative limits may be more effective.¹⁰⁴ They can also be more effective than attempting to influence financial institution cost and profitability.¹⁰⁵ For example, during periods of intense competition for market share price signals are likely to be ignored by senior management and lending standards relaxed.¹⁰⁶ Based on my personal experience senior executives and boards may become obsessed with “the chase” seeking to keep-up with, or to over-take, rival companies. During these periods of excitement and intense pressures market signal are often ignored or their importance explained away. For example, in 2006-2007 Northern Rock, a small regional UK bank, expanded its mortgage book very rapidly and grew its new business market-share to almost 19% in July 2007 just before it collapsed.¹⁰⁷ It aimed to over-take Halifax Bank of Scotland, the market leader. There was considerable liquidity in the market with rapidly rising house prices and very high levels of mortgage lending. There were many new non-deposit taker entrants in the market and lending margins fell to zero or lower. The signs

¹⁰³ HM Treasury, ‘The Financial Policy Committee’s housing market tools’, (October 2014), 5. The measures were first announced by the Chancellor of the Exchequer in his Mansion House speech on 12th June 2014 and followed up by a H M Treasury consultation mentioned above and a policy statement commenting on the responses to the consultation in January 2015 (H M Treasury, ‘Detail of outcome from FPC’s housing market tools consultation’) together with a Statutory Instrument laid before Parliament and approved by both Houses implementing the new policy (The Bank of England Act 1998 (Macro-prudential Measures) Order 2015)

¹⁰⁴ Gianni De Nicoló, Giovanni Favara, and Lev Ratnovski, ‘Externalities and macroprudential policy’, (2012), IMF Staff Discussion Notes, No. SDN/12/05, 12

¹⁰⁵ Ibid, 8

¹⁰⁶ For example, Halifax Bank of Scotland (HBOS), in the years preceding the financial crisis, faced increasing competition in its core business of providing residential mortgages and in order to retain its market share and profitability “HBOS expanded its mortgage activities in less competitive areas, such as self-certification [where the borrower provided no evidence of their claimed income] and buy to let mortgages, where margins were higher ... By 2007, 27% of mortgage lending exposure was in “specialist lending” [ie self-certification mortgages at around £30Bn].” The “buy-to-let mortgage portfolio was the area of real growth, almost doubling to £27 billion between 2006 and the end of 2007, where maintaining market share also meant moving up the risk curve.” Bank of England and Financial Conduct Authority, ‘The failure of HBOS plc (HBOS)’, (2015), 115

¹⁰⁷ ‘*Northern Rock boasts 18.9% net market share*’, Mortgage Strategy, (25th July 2007), “Looking at residential mortgages, our gross lending for the year was 23% higher at £29.0 billion and net lending was 13% higher at £15.1 billion, again with a strong second half performance...economic fundamentals are set to remain supportive for the mortgage market - our core market.”, Northern Rock, ‘Annual report and accounts 2006’, 8-9

indicated a “Minsky moment” and the need for great caution. Some, with better management heeded the warnings and left the market. However, others continued to fuel the market with increased lending in a dash for market-share and positive recognition by the mortgage media.¹⁰⁸

There were major failures of corporate governance.¹⁰⁹ The imposition of increased capital and liquidity requirements in the period before the recent financial crisis are unlikely to have been effective unless imposed very early on before the asset and credit boom was well underway. However, LTV and DTI limits would have had an immediate effect and would have provided a clear signal to lenders and the market. Moreover, these types of restrictions could be used to target the highest areas of risk such as lending to the speculative residential property market.

Nevertheless, it is important to note that measures such as LTV and DTI limits only apply to new lending and not to the “stock” or back-book of loans. Excessive risks may already exist in this part of the lender’s balance sheet. Increased capital and liquidity requirements may be used to address these risks. The effect could be a search for more capital and liquidity or de-leveraging the assets portfolio or a mixture of both. This may result in systemic problems, risk contagion and “fire-sales” as lenders compete to sell loan books and other assets and thus “signal” concerns to the rest of the market. This could generate a need to revalue assets and could result in a threat to the solvency of lenders.

Consequently, measures aimed at reducing systemic risk could precipitate it. This is the main reason why it is difficult to employ additional capital and liquidity requirements as short-term macroprudential tools. They work better at the microprudential level over longer periods. There are a number of other significant difficulties arising from the use of LTV and DTI tools and these are considered in the next section.

3.7 When to apply LTV and DTI restrictions and other options

More broadly, there are a number of issues with macroprudential tools, including LTV and DTI measures. These include problems with the accessibility of timely and accurate data,

¹⁰⁸ ‘*Northern Rock has been voted best overall lender in the 2006 Alexander Hall awards*’, Mortgage Solution, 29th January 2007

¹⁰⁹ ‘The run on the Rock’, House of Commons Treasury Committee, Fifth Report of Session 2007–08, HC 56–I [Incorporating HC 999 i–iv, Session 2006–07] Published 26 January 2008, 18–19

which may determine whether it is necessary to deploy macroprudential tools and their calibration. For example, as mentioned earlier, rapid credit growth is often seen as an important factor in the development of systemic financial instability. Consequently, considerable reliance is now placed on credit growth data in relation to GDP.¹¹⁰ A more qualitative method has been suggested using regular surveys of senior lender credit officers assessing levels of relaxations in lending policies.¹¹¹

These data issues mean that it is very difficult to know when to apply LTV and DTI restrictions and how to calibrate them.¹¹² It appears, for example, that LTV limits applied at the peak of the property cycle have the most effect since these loans are the most vulnerable.¹¹³ There are many other potential problems with the use of LTV and DTI tools. These include their social cost, their potential to distort the market, their social and political legitimacy, their effectiveness in restraining credit, the difficulties in measuring their effectiveness and their interaction with other policies including microprudential tools and macroeconomic and fiscal measures.

There are a number of measures that can be used to address these issues. These are considered both in this chapter and in chapter 8 which considers the political aspects of credit and housing policy. These steps can be categorised into three groups with an additional fourth strategy with much broader implications. First, those that allow LTV and DTI tools to be precisely targeted with, for example, some reference to limiting the restrictions for young first-time buyers or only in applying them to properties in certain geographical zones. Second, there are approaches which attempt to address the legitimacy issue by placing responsibility for how the tools are employed on the lenders. For example, allowing the latter to lend a fixed proportion of mortgages above the restricted level. This places the rationing decision in the hands of the lender and distances

¹¹⁰ Rochelle Edge and Ralf Meisenzahl, 'The unreliability of credit-to-GDP ratio gaps in real time: implications for countercyclical capital buffers', (2011) *International Journal of Central Banking*, Vol. 7(4), 261, 262-264 and 296. Part of the problem relates to significant subsequent revisions made to GDP figures and the number of "false positives" which erroneously indicate large increases in credit

¹¹¹ Supra chapt 2, n151, (Bassett, 'Changes in bank lending standards and the macroeconomy'), 27

¹¹² Ian Christensen, 'Mortgage debt and procyclicality in the housing market', (Summer 2011) *Bank of Canada Review*, 35-42, 39 considers the use of automatic LTV restrictions linked to the rise of house prices but does not mention the risks of "leakages" and other forms of limit avoidance which appear to develop the longer LTV constraints apply

¹¹³ Niamh Hallissey, Robert Kelly and Terry O'Malley, 'Macroprudential tools and credit risk of property lending in Irish banks', (2014) *Central Bank of Ireland, Economic Letter Series*, No. 10, 3

it from the macroprudential policymakers. It is, in many ways, akin to the operation of macroprudential tools that raise the cost of lending, mentioned earlier, where the effects of these measures are issues for the management of the regulated firm to resolve. Third, there are public policy actions that mitigate the effects of LTV and DTI limits, for example, by subsidising deposits and mortgage insurance. All of these work by manipulating the supply of credit. The final measure is even broader and has a central objective of increasing the supply of housing. This addresses a number of issues including reducing the cost of buying a home through increased supply and hence reduces the demand for credit. It clearly has a number of socio-economic aspects some of which are considered in chapter 8.

3.8 Other concerns

There are other concerns with the use of LTV and DTI tools. These include the ability of lenders and borrowers to evade their effects; know as “leakages”; the failures of these measures to address root causes and the effects of unintended consequences.

“leakages”

The Bank of England has looked at the issue of “macroprudential ‘leakages’” in relation to the use of capital tools, using overseas branches operating in the UK as a control group.¹¹⁴ It found that a 1% decline in lending by UK authorised banks due to increased capital requirements lead to a 32% “leakage”.¹¹⁵ The effect is material but the Bank still determined that the macroprudential tools were effective.¹¹⁶

At the heart of the issue is that the two main protagonists: the borrower and the lender want to complete the transaction and, possibly, aided by an intermediary broker, may attempt to find ways around the restrictions. It may be undermined by a combination of high levels of housing sales and purchases in an escalating property market as borrowers increase their borrowing in frequent steps without breaching LTV limits. Some of these

¹¹⁴ Shekhar Aiyar, Charles Calomiris and Tomasz Wieladek, ‘Does macropru leak? Evidence from a UK policy experiment’, (2012) Bank of England Working Paper No. 445, 4. This supported by further work by the same authors, ‘Identifying channels of credit substitution when bank capital requirements are varied’, (2014) Bank of England Working Paper No. 485, 7-8

¹¹⁵ Ibid, (Aiyar, Calomiris and Wieladek), 4

¹¹⁶ Ibid, (2012), 28

aspects are considered later as part of the analysis of how LTV and DTI restrictions have worked in other jurisdictions. For example, side arrangements between borrowers and property-site developers may provide some, or all, of the higher deposit required under a LTV macroprudential policy.¹¹⁷ In another example, non-bank intermediaries and foreign financial institutions may become active and reduce the effect of the macroprudential measures.¹¹⁸ Additionally, deposits may be funded by unsecured loans perhaps backed by various forms of credit insurance or conditional ownership contracts.

The Bank of England is aware of these issues.¹¹⁹ However, since LTV and DTI policies have only had limited application in the UK, it is not clear what the response may be if, and when, they are applied. Other jurisdictions have had more experience of these issues and these are considered later in this chapter. All this emphasises the need for cross-border macroprudential cooperation.¹²⁰ This is not new since, for example, the methods used to avoid compliance with the supplementary special deposit scheme (“the corset”) in the 1970s, included the use of overseas operations and “disintermediation of a purely cosmetic nature”.¹²¹

¹¹⁷ ‘*The Council of mortgage lenders (CML) and the Royal Institute of Chartered Surveyors (RICS) in talks over bogus new build buy-to-let (B2L) valuations*’, (Mortgage Strategy, 23rd December 2005), “concerns over bogus new build buy-to-let valuations, as industry confidence in new build continues to waver. Two weeks ago Portman subsidiary The Mortgage Works made an official decision not to lend on new build properties as a result of concerns that some developers were doing deals on the price of the property outside of the formal contract.” See also The Telegraph, ‘*Five dirty tricks in today’s rising housing market*’, (3rd October 2013) refers to practices in 2006/7 of “‘fake’ discounts on newly built properties” and “no money down property deals with ‘property clubs’”

¹¹⁸ For example, although not directly in relation to a macroprudential interventions a lender based in the Czech Republic has started offering non-document mortgages in the UK via the internet. This type of mortgage was effectively banned by the FCA, (‘*Self-cert mortgages return as new lender opens*’, Mortgage Strategy, 18th January 2016

¹¹⁹ Jon Cunliffe, remarks at the Alastair Ross Goobey Memorial Lecture, London, 26th April 2016 in which he describes how “nearly 15% of new mortgages...had loan to income ratios just below the FPC’s threshold of 4.5 almost double the proportion in 2008/9”. (page 5). See also Bank of England, ‘The Financial policy Committee’s powers over housing policy instruments: a draft policy statement’, (November 2016), 28-29

¹²⁰ Ignazio Angeloni, ‘European macroprudential policy from gestation to infancy’, (April 2014) Banque de France, Financial Stability Review, No. 18, 71-84, 81

¹²¹ Bank of England, ‘The supplementary special deposits scheme’, (March 1982) Quarterly Bulletin, 74-84, 82

Socio-economic root cause analysis

There is a concern that the focus of macroprudential tools, in general, and LTV and DTI measures, specifically, has been too numeric and formulaic.¹²² Economic studies fail to consider the root cause of financial instability including behaviours that are evidence of “rent-seeking” and risk-taking (eg looser contractual terms, more new financial products etc).¹²³ These issues are bound up in wider economic concerns over the globalisation of capital flows, serious economic imbalances, social inequality and the reliance on debt.¹²⁴ These aspects go beyond the subject of this thesis, but are legitimate issues against which to assess macroprudential policy.

Possible unintended consequences of LTV and DTI macroprudential policies

There is a risk that uncoordinated macroprudential policies can “spillover” from one country to another. This is important since foreign bank branches in the UK are an important factor in the latter’s domestic economy; more so than in that of other developed nations.¹²⁵ However, in the run-up to the financial crisis overseas branches in the UK provided little credit to UK households.¹²⁶ The role of foreign bank branches is a particular concern when different jurisdictions use different policies to address similar risks. There is evidence that where one jurisdiction increases its lending restrictions that the “UK-resident

¹²² Chapt 2, n152, (Luci Ellis, ‘Macroprudential policy: What have we learned?’), 12

¹²³ Ibid (Luci Ellis), 11. See also Dimitri Papadimitriou, Edward Chilcote and Gennaro Zezza, ‘Are housing prices, household debt and growth sustainable?’, (January 2006) Strategic Analysis, The Levy Economics Institute of Bard College, looks at mortgage borrowing flows used to support consumer expenditure and opines that this type of financing is unsustainable. This develops issues highlighted in an earlier paper by Wynne Godley and others, ‘The United States and her creditors: can the symbiosis last?’, (September 2005) Strategic Analysis, The Levy Economics Institute of Bard College

¹²⁴ Martin Wolf, *The shifts and shocks*, (Penguin, London, 2015), 158-173 and Turner, *Between debt and the devil*, supra note 1, 94-97; stating that there is too much “inequality and unnecessary credit” (page 108) and that governments have been too eager to use mortgage credit as a “costless answer enabling low-income citizens to finance consumption”, (page 121). See also Raghuram Rajan, ‘Let them eat credit’, (New Republic, 27th August 2010), summarising the main argument in his book: *Fault lines: how hidden fractures still threaten the World economy*, (Princeton University Press, Princeton, New Jersey, 2010)

¹²⁵ Robert Hills and others, ‘Cross-border regulatory spillovers: How much? How important? What sectors? Lessons from the United Kingdom’, (2016) Bank of England Staff Working Paper No. 595, 2, “foreign banks account for nearly half of total banking system assets in the UK, amounting to around 250% of GDP (of which around three-quarters is accounted for by branches, and the remainder by subsidiaries)”

¹²⁶ Glenn Hoggarth, John Hooley and Yevgeniya Korniyenko, ‘Which way do foreign branches sway? Evidence from the recent UK domestic credit cycle’, (2013) Bank of England Financial Stability Paper No. 22, 12

affiliates owned in that jurisdiction expand ... household lending in the UK".¹²⁷ However, another study could find no statistically significant evidence of any "spillover" of increased lending when the home country increases lending standards regulation.¹²⁸

The political legitimacy of using LTV and DTI policies is a more significant issue. This is considered briefly in the next section and in more detail in chapter 6.

The legitimacy of LTV and DTI macroprudential policies

Very few of the studies of the macroprudential use of LTV and DTI limits consider, or even mention, issues concerning the political legitimacy involved in their use.¹²⁹ There are clearly groups who will be adversely affected by the application of LTV and DTI macroprudential policies. It is possible, when organised by pressure groups, politicians and the media that these measures, and those responsible for them, may be subject to intense scrutiny and questioning including the legitimacy of their actions.¹³⁰ This important issue is addressed in chapter 6.

Consequently, political pressure may limit the effectiveness of macroprudential restrictions on mortgage lending. Nevertheless, jurisdictions operating under different political norms such as Hong Kong, Singapore and South Korea have consistently been able to apply more robust macroprudential policies in the mortgage market.¹³¹ The use of LTV and DTI limits in specific jurisdictions is considered later in this chapter after a broader review of the effectiveness of these policies covered in the next section.

¹²⁷ Supra, note 125, (Hills and others), 4. See also Steven Ongena, Alexander Popov and Gregory Udell 'When the cat's away the mice will play': does regulation at home affect bank risk-taking abroad?' (2013) *Journal of Financial Economics*, Vol. 108, Issue 3, 727, 742, found that "in markets with weak supervision, strict [restrictions on lending] regulation can be more efficient in restricting bank risk taking, pushing banks to shift risk-taking abroad"

¹²⁸ Piotr Danisewicz, Dennis Reinhardt and Rhiannon Sowerbutts, 'On a tight leash: does bank organisational structure matter for macroprudential spillovers?', (2015) Bank of England Working Paper No. 524, 6 and 13-14

¹²⁹ For example, Luis Jácome and Srobona Mitra, 'LTV and DTI limits - going granular', (2015) IMF Working Paper WP/15/154, appears to regard the use of such measures are purely a technical matter. See supra, note 47, (Lambertini, Mendicino and Punzi), 15-16

¹³⁰ Supra note 48, (Dell'Ariccia, 'policies'), 27

¹³¹ Salim Darbar and Xiaoyong Wu, 'Experiences with macroprudential policy - five case studies', (2015) IMF Working Paper WP/15/123, 4-9 and 24-29

3.9 The effectiveness of LTV and DTI policies

There is evidence that lending based on high LTVs and DTIs is more susceptible to economic shocks.¹³² Consequently, macroprudential tools that restrict high LTVs and DTIs may be more effective than other options.¹³³ However, there is a general paucity of data on which to base LTV and DTI decisions. As a result much of the policymaking in this area is based, in practice, on a set of best estimates.¹³⁴ This section looks at the effectiveness of the applications of these types of macroprudential measures; and their political acceptability.

There are a number of methods of applying LTV and DTI limits. For example, in Hong Kong LTV restrictions are set in the form of a “ladder” with different levels of LTV applied to a range of property values. This is considered in more detail below. In the UK, DTI limits may be applied to percentages of the lender’s loan book.¹³⁵ Further, it has been suggested that LTV limits should be applied automatically, linked to a counter-cyclical macroprudential strategy.¹³⁶

In the US the highest LTV and DTI levels were seen in the period 2005-2007 and it is the mortgages sold in these years that are the most likely to have resulted in financial

¹³² Owen Lamont and Jeremy Stein, ‘Leverage and house-price dynamics in US cities’, (1999) *RAND Journal of Economics* Vol. 30, No. 3, 498, 514. See also Heitor Almeida, Murillo Campello and Crocker Liu, ‘The financial accelerator: evidence from international housing markets’, (2006) *Review of Finance*, Vol. 10, 1

¹³³ It is worth noting that, counter-intuitively, neither LTV nor DTI levels appear to affect borrower non-housing consumption expenditure as measured across a range of countries, Alessandro Calza, Tommaso Monacelli, and Livio Stracca, ‘Housing finance and monetary policy’, (2009) European Central Bank Working papers Series No.1069, 8. See also Chris McDonald, ‘When is macroprudential policy effective?’, (2015) BIS Working Papers No 496

¹³⁴ Stanley Fischer, ‘Financial sector reform: how are we?’, Martin Feldstein lecture at the National Bureau of Economic Research, Cambridge, Massachusetts, 10th July 2014, 11

¹³⁵ Financial Policy Committee, ‘Statement on housing market powers of direction from its policy meeting, 26 September 2014’, issued 2nd October 2014, 60

¹³⁶ Caterina Mendicino, ‘Collateral requirements: macroeconomic fluctuations and macroprudential policy’, (2012) Banco de Portugal Working Papers 11/2012, 3. This is supported by Ian Christensen and Cesaire Meh, ‘Countercyclical loan-to-value ratios and monetary policy’, (2011) Bank of Canada mimeo, 25. See also supra, note 88, (Bianchi and Mendoza, 2011), Prakash Kannan, Pau Rabanal, and Alasdair Scott, ‘Monetary and macroprudential policy rules in a model with house price booms’, (2012), *The B.E. Journal of Macroeconomics*, Vol. 12, Issue 1, Article 16, 2. Paolo Angelini, Stefano Neri and Fabio Panetta, ‘Monetary and macroprudential policy’, (2012) European Central Bank Working Paper Series No. 1449, 2

difficulties or default.¹³⁷ The other predictor of financial difficulty is a correlation between those with first charge mortgages with an LTV over 80% supplemented by a second charge.¹³⁸ This suggests that borrowers had found ways of circumventing some lender restrictions by using loans from other less rigorous lenders. Further, it is possible that increasing LTV requirements, or higher interest rates, may deter better risk customers, with lenders subject to adverse selection.¹³⁹

It is difficult to determine how effective quantitative limits on lending are in practice. In order to avoid regulatory arbitrage, the various limits need to apply to any financial service firm capable of offering mortgages and not just to banks and building societies.¹⁴⁰ I have discussed the effect of the DTI limitations, mentioned earlier, imposed by the Bank of England in 2014, with heads of mortgage credit at six out of the seven major lenders.¹⁴¹ They have all had to impose much lower restrictions on the percentage of business that can be undertaken at these high multiples to ensure that there is a sufficient buffer so that the lender did not fall foul of the Bank of England restrictions. The limit is imposed on drawdown rather than commitment so the various credit departments have had to develop forecasting models since there is normally a two to three month gap between these two dates. In practice, some lenders have had, suddenly, to cease offering these levels of mortgage with the result that mortgage brokers have directed all the business to competitors. This has had a cascade effect across the mortgage industry with a series of “stops and starts”. However, from discussions with the mortgage brokers trade body, there has always been at least one lender able to meet borrower demand. The Bank of England has confirmed that after a short-term slow-down lending at high DTI levels has resumed

¹³⁷ Yuliya Demyanyk and Otto Van Hemert, ‘Understanding the subprime mortgage crisis’, (2008) Federal Reserve Board of St. Louis Supervisory Policy Analysis Working Paper, 1-7, with LTVs of between 84-86% and DTIs over 40%

¹³⁸ Manuel Adelino, Antoinette Schoar and Felipe Severino ‘Credit supply and house prices: evidence from mortgage market segmentation’, (2012) National Bureau of Economic Research Working Paper 17832. This is based on a large sample of transactions across ten US cities which indicates that this method of finance grew extensively in 2004-6, (page 36)

¹³⁹ Joseph Stiglitz and Andrew Weiss, ‘Credit rationing in markets with imperfect information’, (June 1981) *The American Economic Review*, Vol. 71, 393-410, 408-409

¹⁴⁰ Chapt 2, n34, (Crowe), 20

¹⁴¹ RBS declined to be interviewed in view of the sensitivity of its position

with “nearly 15% of new mortgages” written, in the fourth quarter of 2015, at “ratios just below the FPC’s threshold of 4.5 – almost double the proportion in 2008/9”.¹⁴²

One possible option would be to impose a limit on the enforceability of the mortgage security above a set LTV limit.¹⁴³ This would limit the risk of “leakage” since it would be difficult to avoid. However, lenders may, for example, be able to source low cost insurance for the excess amount or simply accept the risk for the unsecured portion of the loan, especially in a rising property price market. It is also possible that the microprudential supervisors may be concerned since this may complicate the capital risk weighting calculations and undermine part of the prudential security of lenders.

The next section looks at the experience of a number of jurisdictions which have employed LTV and DTI measures.

3.10 The effectiveness of LTV and DTI measures: the experience of other jurisdictions

3.10.1 Cross-border surveys

A few countries since the late 1990s have operated LTV and DTI restrictions. Analysis of their effectiveness has been limited. This is probably due to the idiosyncrasies of the housing markets in each jurisdiction and the complexity caused by other interventions including, government housing policies, taxation and macroeconomic actions.

Nevertheless, there are some general lessons which may be drawn from the experience of others. This section looks at the five major cross-border surveys in this area. This is followed by a review of the results and issues found in five individual jurisdictions (ie Sweden, Korea, Israel, New Zealand and Hong Kong). Finally, reference is made to the introduction of LTV and DTI restriction in the Republic of Ireland in 2015. The Irish central bank has tried to learn from other jurisdictions and to apply its policies in its own context although it is too early to analyse the results for these measures.

¹⁴² Supra note 119, (Cunliffe at Goobey Lecture, 2016)

¹⁴³ Mark Stephens and Peter Williams, ‘Tackling housing market volatility in the UK: a progress report’, (2012), Joseph Rowntree Foundation Report, 7

3.10.2 Multi-jurisdictional surveys

A review of some 2,800 banks across forty-eight countries over the period 2000-2010 found that LTV and LTI policies had a statistically significant effect on reducing bank balance sheet asset growth.¹⁴⁴ This is in contrast to counter-cyclical capital measures which had no such effect.¹⁴⁵ Another survey based on seventy-four banks in Asia across eleven economies between 2000 and 2014 found that macroprudential policy in Asian countries used housing based tools rather than other policies to curb credit growth. This review found that LTV and DTI limits, higher risk weights requirements on mortgage loans and the taxation of land and property had the biggest effects.¹⁴⁶

Another survey of fifty-seven economies over some thirty years from 1980 found that policies limiting the supply of credit by increasing its cost had “little or no detectable effect on the housing market.”¹⁴⁷ However, DTI measures were more effective in controlling the demand for credit than LTV policies probably because rising property prices negated the latter’s effect.¹⁴⁸ It is interesting to note that neither set of actions had any clear effect on house prices.¹⁴⁹

A survey of 119 countries between 2000 and 2013 found that LTV and LTI limits were “associated with reductions in the growth rates in credit and house prices”.¹⁵⁰ These actions, together with leverage limits and dynamic provisioning were particularly effective

¹⁴⁴ Stijn Claessens, Swati Ghosh, and Roxana Mihet, ‘Macroprudential policies to mitigate financial system vulnerabilities’, (2014) IMF Working Paper WP/14/55, 17. See also earlier work by Cheng Lim and **others** ‘Macroprudential policy: what instruments and how to use them? Lessons from country experiences’, (2011), IMF working Paper 11/238, 27

¹⁴⁵ Ibid, 17 (Claessens, Ghosh and Mihet)

¹⁴⁶ Longmei Zhang and Edda Zoli, ‘Leaning against the wind: macroprudential policy in Asia’, (2014) IMF Working Paper WP/14/22, 9 and 30

¹⁴⁷ Kenneth Kuttner and Ilhyock Shim, ‘Can non-interest rate policies stabilise housing markets? Evidence from a panel of 57 economies’, (2013) BIS Working Papers No 433, 24-25

¹⁴⁸ Ibid, 24-25. Chapt 2, n116, (CGFS Papers No. 48), 56-57, which suggests that the DTI policies work better during periods of rapid house price inflation since income levels do not rise as fast. See also Gabriele Galati and Richhild Moessner, ‘What do we know about the effects of macroprudential policy?’, (2014) DNB Working Paper No. 440

¹⁴⁹ Supra note 147, (Kuttner and Shim), 24-25

¹⁵⁰ Eugenio Cerutti, Stijn Claessens, and Luc Laeven, ‘The use and effectiveness of macroprudential policies: new evidence’, (2015) IMF Working Paper WP/15/61, 3

although the evidence of their effectiveness is weaker “in financially more open economies and those economies that have deeper and presumably more sophisticated financial systems, suggestive of some evasion.”¹⁵¹

It has been pointed out that these multi-jurisdictional surveys fail to take account of important local characteristics, including the quality of microprudential supervision, the phasing of local credit expansions and contractions, fiscal policies in relation to housing and the role of capital markets and non-bank financial institutions.¹⁵² Moreover, the range of countries is very wide including a host of different political systems and economic conditions. In other words, there are probably too many variables to draw any useful conclusions. Consequently, it may be more useful to consider a number of specific jurisdictions that have employed LTV and LTI measures in recent years.

The next section analyses a representative group of jurisdictions; some are selected both for the period of time over which they have deployed LTV and LTI policies and the intensity of their application and others because they display, clearly, some of the fundamental issues with the use of these instruments. Some jurisdictions have been excluded, since their residential property macroprudential policies are so entwined with their taxation systems that it is very difficult to assess the success or failure of the former. For example, the Netherlands introduced a cap on LTV lending in 2013 of 105%, set to decrease to 100% by 2018.¹⁵³ Not only is this a very high LTV but new mortgages qualify for interest tax deductibility, which has a distorting effect on the market.

Canada presents particular issues. It is difficult to discern what is happening in the Canadian housing market since there are a large number of factors influencing both the process and outcomes. First Canada is not one market but several with areas such as the Toronto metropolitan district, British Columbia and the other western provinces operating as distinct markets with very different dynamics to each and the rest of the country.¹⁵⁴ Moreover, the mortgage market is dominated by the big four federally regulated banks and

¹⁵¹ Ibid, 3

¹⁵² Supra, chapt 2, n105, (Claessens, ‘An overview of macroprudential policy tools’)

¹⁵³ Supra, note 131, (Darbar and Wu), 15-16

¹⁵⁴ Lawrence Schembri, ‘Housing finance in Canada: looking back to move forward’, (November 2014) National Institute Economic Review, No. 230, 53

almost all high-LTV mortgages must have credit insurance issued by the Federal Canada Mortgage and Housing Corporation (CMHC) or equivalent private sector insurer.¹⁵⁵ Since 2008 the government has changed its restrictions on LTVs and debt service ratios especially for investment properties and limited access to mortgages for those with poor credit scores.¹⁵⁶ In addition, limited competition among lenders, a high propensity for borrowers to pay down their mortgages as early as possible and the introduction of a very high foreign-buyer tax in 2016 in British Columbia and a year later in Toronto make it further difficult to draw broad lessons from the Canadian experience of LTV measures.¹⁵⁷ These measures appear to have been effective for owner-occupied properties while “the growth of residential investment recovered to levels above those before the first round of tightening... and that most effects have since dissipated.”¹⁵⁸

Both Korea and Hong Kong are included since they both adopted LTV and DTI limits following the Asian financial crisis in the 1990s and consequently have the longest history of the application of these policies and their effectiveness. Sweden is covered since it highlights the less than coordinated approach to macroprudential and monetary policies.¹⁵⁹ This chapter also considers Israel’s macroprudential LTV policies since it highlights issues where LTV policies were challenged as part of the social and political process. New Zealand is included rather than Eire since the latter’s LTV and LTI limits were introduced more recently in 2015 and are similar to those recently set by the Bank of England and are largely modelled on the New Zealand policies.¹⁶⁰

¹⁵⁵ Ibid, 48

¹⁵⁶ Jason Allen and others, ‘The impact of macroprudential housing finance tools in Canada: 2005–10’, (August 2016), Bank of Canada Staff Working Paper 2016-41, 1

¹⁵⁷ Ontario, Ministry of Finance web-site, ‘Fair Housing Plan: Non-Resident Speculation Tax’, <https://www.fin.gov.on.ca/en/bulletins/nrst/nrst.html>, (accessed 21st September 2017)

¹⁵⁸ Martin Kuncl, ‘Assessment of the effects of macroprudential tightening in Canada’, (August 2016), Bank of Canada Staff Analytical Note 2016-12, 5

¹⁵⁹ Wall Street Journal, ‘Sweden plans tighter mortgage rules to tackle household debt - Swedish financial watchdog seeks to cool borrowing as interest rates remain low’, (11th November 2014), “The central bank, the Riksbank, has long warned that Swedish private debt levels are rising too rapidly”

¹⁶⁰ Irish Central Bank (Supervision and Enforcement) Act 2013 (Section 48) (Housing Loan Requirements) Regulations 2015 and ‘Information note: Macro-prudential policy for residential mortgage lending’

Sweden

Swedish macroprudential policy is governed by the Swedish Council for Cooperation on Macroprudential Policy with joint representation by the Riksbank (the central bank) and the Finansinspektionen (the financial supervisory authority with the roles of promoting stability and efficiency in the financial system as well as ensuring consumer protection). The Council was concerned about increasing mortgage lending and especially the increase in new lending and higher LTVs.¹⁶¹ Shortly afterwards, in 2013, the Council was replaced by the Financial Stability Council chaired by the Minister for Financial Markets with representatives from the Finansinspektionen, the Swedish National Debt Office and Sveriges Riksbank.¹⁶² Macroprudential regulation is the responsibility of Finansinspektionen since it already undertakes microprudential regulation and it appeared convenient to have both areas covered by the same body. It is also possible that there was a political purpose in this arrangement, since Finansinspektionen is a government agency.

Nevertheless, the Riksbank, as an independent central bank, still issues its regular financial stability reports and, as mentioned earlier, has continued to express concern about the lack of clarity regarding who has responsibility for macroprudential regulation.¹⁶³ A LTV limited of 85% was introduced in 2010, but Finansinspektionen appears not to have the power to introduce a LTI restriction and Swedish households remains, paradoxically, one of the highest savers and most indebted in Europe.¹⁶⁴ Finansinspektionen has also imposed requirements that all new mortgages with LTVs over 70% must be paid down to at least 50% of LTV at a rate of 2% each year.¹⁶⁵

¹⁶¹ Council for Cooperation on Macroprudential Policy minutes, (1st October 2013)

¹⁶² Swedish Riksbanks website: The Council for Cooperation on Macroprudential Policy/Financial Stability Council (from 2013), <http://www.riksbank.se/en/Financial-stability/The-Financial-Stability-Council/Council-for-cooperation-on-macroprudential-supervision/> (accessed 29th June 2017)

¹⁶³ Riksbanks, 'Financial Stability Report', (2015:2), 16-17. The report has also recommended changes to a variety of areas such as the level of mortgage interest allowed for tax deduction purposes and standardised affordability tests as part of the credit assessment by the lender, pages 20-21

¹⁶⁴ ESRB, 'Vulnerabilities in the EU residential real estate sector', (November 2016), 117-121

¹⁶⁵ Finansinspektionen, 'Amortisation requirement for new mortgages', (11th March 2015)

South Korea

Korea deregulated the financing of its housing market in the 1990s. Commercial banks were able to make mortgage loans and the Korean Housing Banks which had previously monopolised the mortgage market were privatised in 1997. Following the Asian financial crisis in the late 1990s, LTV limits were introduced in 2002 and DTI limits in 2005.¹⁶⁶ The Korean Financial Supervisory Service created a macroprudential supervision department to assess macroprudential risk which set LTV and DTI limits at different rates depending on where the mortgage properties were located, who the purchasers were, their age and marital status etc.¹⁶⁷ Between their introduction and 2014, LTV and DTI have been adjusted some nine times with the LTV limits moving within a 40-70% range.¹⁶⁸ The picture is complicated by a number of government interventions, including taxation changes, financial support for both public and private home construction and government building of new houses and buying existing homes depending on market conditions and political expediency.¹⁶⁹ In addition, the Bank of Korea employs price-based tools (eg macroprudential stability levies) to promote financial stability.¹⁷⁰ However, the LTV and DTI restrictions seem to have had a number of unintended effects including, increases in non-bank mortgage lending, and a lengthening of the term of mortgages.¹⁷¹

The results appear to demonstrate a reduction in housing transactions and a slowing in the growth of property prices in the months following an increased restriction in LTV and

¹⁶⁶ Deniz Igan and Heedon Kang, 'Do loan to value and debt to income limits work? Evidence from Korea', (2011) IMF Working Paper WP 11/297, 7

¹⁶⁷ Ibid, 24

¹⁶⁸ Choongsoo Kim, (Governor of the Bank of Korea), 'Macroprudential policies in Korea: key measures and experiences', (2014) Banque de France Financial Stability Review, issue 18, 125

¹⁶⁹ Supra, note 166, Igan and Kang, 7

¹⁷⁰ Supra, note 168, Kim C, 126

¹⁷¹ Supra, note 168, Kim C, 126. In addition, Korea has its own form of rental market known as the "Chonseil system". Some 55% of homes are owner-occupied and over 20% of properties are rented on a conventional basis but over 22% nationally, rising to more than 33% in very high-value areas such as Gangnam in Seoul, are occupied using the Chonseil system. Under this arrangement between 50-90% of the value of the property is deposited with the owner by the occupier for two to three years. The owner then earns interest on this sum. At the end of the agreed period the deposit is returned. There has been a public sector version of the system since 2011. Many of the owners are themselves tenants who own a number of Chonseil properties to supplement their income, Soosung Hwang, Sanha Noh and Jinho Shin, 'The price impact of deposit in residential lease contracts: the collapse of Chonseil system in Korea', (2015), this paper argues that the system is in decline due to the prevalence of low interest rates

DTI limits as plans to buy a new home are postponed.¹⁷² However, the main effect of these measures is to signal to market speculators reduced property price growth expectations.¹⁷³ This is particularly relevant since the growth in credit and property prices in Korea is blamed on in-flows of capital from outside the country and the macroprudential measures have reduced the attractiveness of Korea for these capital movements.¹⁷⁴

Israel

Although Israel did not suffer a financial crisis in 2007/8, it has faced similar problems to other developed economies with low interest rates and rapidly rising house prices. Consequently, the central bank adopted a number of macroprudential policies including increasing the risk weights for loans secured on housing and higher capital requirements.¹⁷⁵ In addition, the Bank of Israel imposed LTV restriction in 2010. However, in the light of political pressure in 2012 the LTV limit was raised to 75% from 70%, for first time buyers and lowered to 50% for those buying a second home.¹⁷⁶ Stanley Fischer has said that the central bank was “subject to far more criticism” over its use of its LTV policies “than over [its] standard monetary policy measures.”¹⁷⁷

The LTV restrictions appeared to have worked for some six months following their introduction but house prices have continued to rise rapidly with none of the macroprudential measures being effective while interest rates were kept low for monetary

¹⁷² Supra, note 166, Igan and Kang, 4. See also Jong Kyu Lee, ‘The operation of macroprudential policy measures, the case of Korea in the 2000s’ in Otaviano Canuto and Swati Ghosh (eds), *Dealing with the challenges of macro financial linkages in emerging markets*, (World Bank Publications, Washington D.C. 2013), 263-269, which suggests that LTV and DTI limits were, to some extent, negated by macroeconomic distortions encouraged banks to lend to home purchasers and deterred commercial borrowing. This has resulted in increases in house prices

¹⁷³ Supra, note 166, (Igan and Kang), 14

¹⁷⁴ Valentina Bruno and Hyun Song Shin, ‘Assessing macroprudential policies: the case of South Korea’, (2014) *Scandinavian Journal of Economics*, Vol. 116(1), 128, 129-131

¹⁷⁵ Stanley Fischer, ‘Macroprudential policy in action: Israel’ in George Akerlof, Olivier Blanchard, David Romer and Joseph Stiglitz (eds), *What have we learned? Macroprudential policy after the crisis*, (MIT Press, Cambridge, Massachusetts, 2014), 93

¹⁷⁶ Ibid, 94. See also BBVA Research, ‘Macroprudential measures on mortgage lending: country experiences’, (2014) *Economic Analysis*

¹⁷⁷ Supra, note 175, (Fischer), 95

policy purposes and capital was readily available.¹⁷⁸ Israel is an example of the difficulties of using macroprudential tools in the face of strong monetary policy headwinds and where LTV policies are challenged as part of the social and political process.

Hong Kong

Even before the Asian economic crisis in the 1990s, Hong Kong had used macroprudential measures to restrain credit growth and the “build-up in leverage”.¹⁷⁹ During the Asian financial crisis Hong Kong house prices fell by 66% but defaults were low and there was no banking crisis.¹⁸⁰ Hong Kong has had LTV limits since the 1990s due to the importance of residential mortgages in the economy and the limits placed on its monetary policy as a result of the Hong Kong dollar’s peg to the US currency. Residential property lending is a significant part of bank lending in Hong Kong. In 1991 LTVs were capped at 70% and in 1996 this was restricted to 60% for what were deemed “luxury properties”.¹⁸¹ Over the years the LTV limits have moved up and down and a debt-service ratio was introduced in 1997 and by 2010 there was a complex LTV “ladder” depending on the value of the property being financed with mandatory credit insurance for loans with high LTVs.¹⁸² Although LTV restrictions have dampened the growth rate of housing market activities and household leverage, it has had little effect on property price growth.¹⁸³

It is worth noting that in 2010 the Hong Kong government introduced a special stamp duty of up to 15% on properties sold within two years of purchase. This was increased to 20% in 2012 for those resold within three years. In 2013 this tax was doubled for all property sales except to local first time buyers.¹⁸⁴ This tax appears to have reduced both demand

¹⁷⁸ IMF Country Report No. 14/48 on Israel, 12. See also the Bank of Israel Financial Stability Report 2015, 4-5

¹⁷⁹ Dong He, ‘Hong Kong’s Approach to Financial Stability’, (2013) *International Journal of Central Banking*, Vol. 9(1), 299, 301. See also Charles Leung and Edward Tang, ‘Comparing two financial crises: the case of Hong Kong real estate markets’ in Ashok Bardhan, Robert Edelstein and Cynthia Kroll (eds), *Global housing markets: crises, policies, and institutions*, (Wiley, Hoboken, New Jersey, 2011)

¹⁸⁰ *Ibid*, Dong He, 302

¹⁸¹ *Supra*, note 176, (BBVA Research), 16-17

¹⁸² *Ibid*, 17

¹⁸³ *Supra*, note 179, (Dong He), 310

¹⁸⁴ Dong He, ‘The effects of macroprudential policies on housing market risks: evidence from Hong Kong’, (2014), *Banque de France Financial Stability Review*, Issue 18, 107

and, consequently, house price growth.¹⁸⁵ It may be that macroprudential policy needs both quantitative controls, such as LTV limits, as well as fiscal measures to be fully effective. This reinforces the view that LTV measures need to be coordinated with other macroprudential and fiscal actions.¹⁸⁶

New Zealand

New Zealand first used LTV limits in 2013, setting a series of “speed limits” on high LTV lending requiring that no more than 10% of a bank’s new mortgage lending could be with LTVs in excess of 80%.¹⁸⁷ There are a number of exemptions including high LTV loan refinancing and home-movers. In addition, capital requirements for residential mortgage loans were increased in September 2013.¹⁸⁸ The New Zealand central bank is concerned about “leakages” since it only regulates banks and is not responsible for other financial sectors and cannot influence funds coming in from overseas.¹⁸⁹ The latter is an important factor since the Reserve Bank wishes to avoid the New Zealand Dollar continuing to rise in value as more investments are attracted to the country.¹⁹⁰

The approaches taken by these different jurisdictions illustrate the difficulties in using LTV and DTI measures for macroprudential policy objectives and the problems in attempting to draw generally applicable lessons for use in other countries. The issues are exacerbated by the variety of policymaking and implementing structures adopted by various jurisdictions.

¹⁸⁵ Ibid, Dong He (2014), 107

¹⁸⁶ Eric Wong and others, ‘Loan-to-value ratio as a macroprudential tool Hong Kong’s experience and cross-country evidence’, (2011), Hong Kong Monetary Authority Working Paper No.01/2011, 22. These findings are also supported by the analysis of Eric Wong, Andrew Tsang and Steven Kong, ‘How does LTV policy strengthen banks’ resilience to property price shocks - evidence from Hong Kong’, (2014) Hong Kong Institute for Monetary Research, Working Paper No.03/2014, 16

¹⁸⁷ Lamorna Rogers, ‘An A to Z of LTV ratio restrictions’, (2014) Reserve Bank of New Zealand: Bulletin, Vol. 77, No. 1, 1

¹⁸⁸ Ibid, 6-7

¹⁸⁹ Ashley Dunstan, ‘The interaction between monetary and macroprudential policy’, (June 2014) Reserve Bank of New Zealand Bulletin, Vol. 77, No.2, 19-20, expresses the view that LTV restrictions can only be temporary otherwise the incentives for “leakage” increase

¹⁹⁰ ‘The introduction of macro-prudential policy’, speech by Graeme Wheeler, Governor of the Reserve Bank of New Zealand, to Otago University, Dunedin, 20th August 2013. See also Lamorna Rogers, ‘A new approach to macro-prudential policy for New Zealand’, (2013) Reserve Bank of New Zealand: Bulletin, Vol. 76, No. 3

3.11 Conclusions

As discussed, macroprudential policy is in the process of development and it operates in an area of considerable complexity combining the effects of microprudential regulation, fiscal measures and monetary policy. Moreover, while some macroprudential tools such as LTV and DTI limits are superficially attractive, in practice their robust use may generate questions about the legitimacy of these tools and the institutions employing them. It is possible that western style democracies may not be able to use them to full effect. Moreover, it is evident from other jurisdictions that LTV and DTI limits may simply not work in the face of market forces, political interference and the lack of any constituency willing to support such measures.

In summary, macroprudential policy needs to be subject to realistic expectations with limited “role responsibility creep” and the policymakers need to establish the public and political legitimacy of their use. Macroprudential policy must be coordinated with monetary and fiscal policy and with those undertaking similar responsibilities in other jurisdictions. Finally, it should not neglect the importance of conduct of business regulation in restricting the growth of credit in the economy. This is the subject of the next two chapters.

CHAPTER 4

Conduct of business mortgage regulation in the UK: origins and concepts and analysis

“We believe that irresponsible borrowing has been just as much a part of the problem in the mortgage market as irresponsible behaviour by firms. Our policy approach to date has been underpinned by a view that mortgage consumers will act rationally to protect their own interests. We believe that we need to change that approach... and be more interventionist to help protect consumers from themselves.”¹

4.1 Introduction

The regulation of financial services’ conduct of business governs how firms in this sector market and sell their products and generally engage with their customers. Although it is an area which is frequently the subject for the personal financial media, it has been, comparatively, little studied. It can be seen as the “poor relation” of the more glamorous prudential and capital markets forms of regulations. It lacks the “theatre” of the trading floor and the larger-than-life personalities and inhabits the world of the ordinary. Its business is a mundane and drab milieu devoid of mystery. Its very ordinariness means that everyone believes that they understand it and consequently, it has merited only limited study. This lack of research interest is particularly true of the residential mortgage market. However, unrestrained mortgage credit has triggered a series of financial crises in the UK and other countries over the last fifty years. In the most recent financial collapse “ordinary” home lending was at the centre of events that almost destroyed the global financial system. Consequently, it is important that regulators at all levels: macroprudential, microprudential and conduct of business, pay attention to the residential mortgage market.

This chapter will demonstrate that there is nothing “ordinary” about the conduct of business regulation of homeowner mortgages. It is difficult to enforce and has a wide

¹ FSA, ‘Discussion Paper: Mortgage Market Review’, (October 2009), 09/3, 14

range of societal consequences which deserve particular policymaking attention. Nevertheless, conduct of business regulation is central to this thesis as a major component of macroprudential regulation with its ability to limit the access to credit in a manner generally understood and more acceptable to politicians, the media and general public than more conventional tools.

Residential housing markets are very specific to each jurisdiction. They have developed as a result of history, culture, economics, taxation policy, land tenure and political drivers. Access to housing in the UK has been an issue of major public concern in the 20th and 21st centuries. Consequently, the ability to secure a mortgage is closely bound-up with the aspiration of homeownership. Nevertheless, extending credit brings with it the risk of default and repossession. This has both significant consequences for individuals, their families and, more widely, for society. How those at risk and the wider economy are protected is the theme of both this chapter and this thesis.

There are a wide range of approaches to regulating this area. They are not mutually exclusive. They include industry codes of conduct, consumer education and information campaigns, the application of selective taxation and subsidies, political control over the planning process to control what can be built and where, central control over what institutions may lend, to whom and how much, monetary policy using interest rates, macroprudential and microprudential controls on lending and conduct of business regulation. Later chapters will consider some of the political aspects of regulation and other options. This chapter looks at the conduct of business regulation of mortgages in the UK and the scope for employing it as a significant macroprudential tool.

In May 2009 the Financial Services Authority (FSA) launched its review, known as the Mortgage Market Review (MMR), of the regulation of the marketing and distribution of domestic mortgages in the UK. The result was that in April 2014 new regulations came into force. The FSA considered that its “existing regulatory framework has been shown to be ineffective in constraining irresponsible high-risk lending and borrowing and there is a general consensus that substantial regulatory policy reform is needed to reduce the probability and dampen the severity of future financial crises.”² At the heart of the new regulations was the wish to ensure that consumers could afford their loans both at

² Ibid, (FSA, ‘Discussion Paper’, October 2009), 9

inception and over the term of the mortgage and are able to repay them. Broadly, this is achieved by providing information to the consumer at various points before the loan is concluded and placing responsibility on the lender to check that the loan is both suitable for, and affordable by, the consumer. It is these elements and their implications that are considered in this chapter.

Section 4.2 of this chapter considers a number of key concepts in understanding the UK conduct of business regulation in the context of the mortgage market including the mortgage distribution structure and the common failure to distinguish between issues relating to mortgage affordability and credit risk by both international and domestic regulatory policymakers. Sections 4.3 and 4.4 look at the origins of the regulation of mortgage advice in the UK, since the history of regulation in this area over a period of almost a quarter of a century has set the foundations for the current approach to regulation. The strong element of path-dependency was responsible for closing off other regulatory options. This is particularly relevant since the current UK conduct of business regulatory model has changed little from that developed in the late 1980s by the regulators set up under the Financial Services Act 1986.³ This approach seeks, as far as possible, to remove risk to the consumer by developing the path-dependent form of regulation adopted to regulate investment business.⁴ It is based on the concept, which can be summed up, as that of the “trusted adviser”. Section 4.5 summarises the “affordability” assessment aspects of new regulations. Sections 4.6 and 4.7 examine the key issues and concepts underlying conduct of business regulation in the area of mortgages. This includes the conceptual confusion embedded in the mortgage advice process of whether regulation in this area is designed to protect lenders or borrowers. The same section also examines the role of consumer information and section 4.8 reviews the pronounced regulatory move

³ Conceptually, the rules looked at how the customer would interact with the investment provider (ie via marketing literature and advertising and interacting with a financial adviser and if things went wrong through the firm’s complaints handling system). The firm must provide standardised information about the product and all its marketing must be fair, clear and not misleading. Financial advisers must be honest and properly trained and provide suitable advice while the complaints process must be fair and timely and provide recourse to the independent Financial Ombudsman Service if the customer still considers that they are not satisfied with the result. Key elements of this model were considered by Alan Brener, ‘The golden threads of compliance’, (1995) *Journal of Financial Regulation and Compliance*, Vol. 3, No. 4, 344-349

⁴ This form of analysis is borrowed from economic work by Paul David and Brian Arthur demonstrated that often consideration of a possible course of action is “locked-in” by historical events, Brian Arthur, ‘Competing technologies, increasing returns, and lock-in by historical events’, (1989) 97 *Economic Journal* 642-665 and Reinhard Schmidt and Gerald Spindler, ‘Path dependence and complementarity in corporate governance’ in Jeffrey Gordon and Mark Roe, *Convergence and persistence in corporate governance*, (Cambridge University Press, Cambridge, 2004), 114

towards a more paternalistic approach to regulation of mortgage business with the “new paternalism” operating at the heart of the MMR while section 4.9 considers the socio-economic implications of the new regulation and the consequential effects on access to secured loans. This latter aspect is considered in more detail in chapter 8 on the UK housing market and its relationship to mortgage regulation.

Sections 4.10 and 4.11 question the level of confidence that regulators can reasonably place on measures designed for consumer protection where parallel regulation has proved generally inadequate in the insurance and investment business sectors. In support of this proposition this chapter considers the past failures of UK conduct of business regulation and the potential consequences if there is a similar failure following the introduction of more prescriptive recent mortgage regulations in 2014. Finally, sections 4.12 and 4.13 set out the argument that a more targeted approach could achieve the consumer protection objectives without the need to deploy blunt-edged regulation. In summary, regulators may be placing too much faith on mortgage conduct of business regulations to protect consumers at the expense of wider socio-economic consequences while the consumer protection and socio-economic requirements could be better balanced by a different approach.

4.2 Key concepts relating to conduct of business regulation

4.2.1 Manufacturer and distributor structure

The investment business regulatory structure is based on business practices which draw a distinction between the “manufacturers” and the “distributors” of financial products and services. For example, the “trusted adviser” with access to the client may assemble a number of investment funds suitable for their client from a range of fund managers. The latter can be described as the “manufacturers” of these funds while the adviser acts as the distributor. As explained earlier financial services regulation imposes a range of different obligations on each business. For example, the advisor has to understand their clients’ needs and to provide suitable advice.⁵ The fund manager, for example, has to look after the clients’ money left with it for safe keeping pending investment in a fund.⁶ The subsequent regulation of investment business has highlighted a continuing tension

⁵ FCA Conduct of Business Rules 9.2.1

⁶ FCA Client Assets Rules: Principle 10 and Guidance 5.1.7

between “manufacturers of products” and “distributors” who sell the investments, all measured in levels of market share, commission payments, “ownership” of the client relationship, with the customer coming last.⁷ This conceptual approach to the conduct of business regulation of the investment business industry is important in understanding the later regulation of mortgage business which, in many ways, not only adopted the same approach to regulation but also a similar market structure and comparable battle for access to customers. Finally, in this area it is important to distinguish between the important credit and affordability assessments both of which need to be undertaken by the lender. These often cause considerable confusion and are considered next. Nevertheless, they are central to both macro and microprudential policy as well as conduct of business regulators.

4.2.2 The issue of credit and affordability assessments

Many of the issues relating to mortgage regulation hinge on a failure to distinguish between the “credit” and “affordability” assessments. The former is part of the prudential steps aimed at protecting the lender. It involves assessing the creditworthiness of the borrower and their ability to meet the servicing costs of the loan and their ability to repay the principle. If, for any reason, the borrower fails to meet their obligations some, or all, of the security may become forfeit and, in the UK, they can be pursued for any outstanding balance through the courts. The assessment of the borrower and the security they are able to provide to cover the lender’s risk, coupled with the lender’s “risk appetite”, have formed a fundamental portion of banking since the business was first developed in its modern form in medieval Italy and Flanders.⁸ However, although closely related to aspects of the credit appraisal, the “affordability assessment” is different in concept, origin and consequence. It is important to emphasize that the latter is regulated in order to protect the borrower, often from their own inclinations, intuitions and folly. The microprudential supervisor will focus on credit while affordability falls within the purview of the conduct of business supervisor.

⁷ Discussed more fully by Kit Jebens, *Lautro, a pioneer regulator 1986-1994*, (private printing, 1997) and Jean-Jacques Laffont and Jean Tirole, ‘The politics of government decision-making: a theory of regulatory capture’, (1991), *The Quarterly Journal of Economics* 106(4), 1089

⁸ James Murray, ‘The Bruges credit and payments systems’ in *Bruges: Cradle of Capitalism*, (Cambridge University Press, Cambridge, 2005) 210-258

Credit and underwriting departments, within banks and other well established lenders, have long been familiar with their traditional role of protecting their employer's business. However, they have had to go through a period of process and cultural adjustment to implement the affordability regulations first promulgated in 2004 in the UK. The requirements have become more onerous and they now need to carry out two separate assessments often using different data, for two different purposes. First protecting the lender from financial loss due to customer default and inadequate security and second, protecting the customer from over-borrowing contrary to the financial services regulations. This can often result in cultural confusion. Organisationally, compliance and credit staff have worked in separate "silos". Credit staff are likely to be highly experienced credit officers with little exposure to others areas of regulation. Secured lending credit staff will normally concentrate on the value and adequacy of the security in relation to the risk exposure in order to ensure that the lender is protected. However, compliance staff come from a variety of backgrounds often with a legal or an operational perspective. In a commercial bank their objective can be summarised as consumer protection and hence protecting the organisation from regulatory and reputational damage. Credit staff will use a specialist language of statistical analysis, determining levels and risks of probability of default, loss given defaults and exposure at default. The credit teams will be part of the business generation process and will work closely with the marketing, distribution and pricing units. Compliance, on the other hand, is exclusively a control function. In the UK it is generally kept separate from the Risk and Legal function.⁹ This often makes for poor communication and understanding between credit and compliance staff who have different objectives, reporting lines and measures of success. These aspects have neither been addressed in the policy deliberations nor in the regulations themselves. This confusion may be seen in regulatory responses to the concerns expressed by the Financial Stability Board (FSB) addressed in the next section.

4.3 Financial Stability Board (FSB) and the regulatory response

The FSB is a transnational body operating through the medium of "soft" law but nevertheless commanding great authority and exercising considerable influence. In its March 2012 publication on the results of its thematic review of domestic underwriting and sales processes the FSB expressed concern that poor underwriting of mortgages could affect

⁹ Iris H-Y Chiu, *Regulating (from) the inside*, (Bloomsbury, Oxford, 2015), 51

global financial stability through the mechanism of international securitisation.¹⁰

Consequently, in April 2012, the FSB issued its Principles for Sound Residential Mortgage Underwriting Practices.¹¹ This document has multiple aims, including protecting borrowers and investors and “limit[ing] the risks the mortgage markets pose to financial stability”.¹²

The Principles cover areas such as debt security and mortgage insurance. However, the Principles also include ensuring that lenders adopt prudent LTV ratios. They went on to state that lenders should verify the income of borrowers and “that lenders ... assess borrowers; ability to service and fully repay their loans without causing the borrower undue hardship and over-indebtedness.”¹³ The FSB’s focus is, appropriately, on the narrow issue of poor quality mortgage lending “infecting” the global securitisation markets and hence international financial stability. However, there are almost no, or only limited, references to the role of consumer protection in either macro or microprudential policy. Based on this it is not clear that other regulators appreciate the difference between “sound underwriting” which protects the lender, and which consequently supports microprudential regulation, and mortgage affordability and repayability which protect the consumer and may, only as a secondary outcome, protect the lender.¹⁴ These two different types of assessment and the organisational and cultural challenges they pose need to be kept in mind when viewing the history and implementation of mortgage regulation.

The protection of the borrower is at the heart of mortgage conduct of business regulation and it adjusts the relationship between two parties; imposing a set of obligations on each with rights and duties. These factors are all within the purview of legal assessment and understanding. In contrast the protection of a lender from financial distress and collapse is fundamentally a question of economic assessment and modelling. As mentioned later these different conceptual positions are often reflected within the organisational structure of lenders with the areas responsible for protecting customers lodged within the Compliance department while those responsible for managing credit risk form an important

¹⁰ FSB, ‘Thematic Review of Residential Mortgage Underwriting and Origination Practices’, (March 2011)

¹¹ FSB, ‘Principles for Sound Residential Mortgage Underwriting Practices’, (April 2012)

¹² Ibid, 1

¹³ Supra note 11, (FSB Underwriting Principles), 2 - 7

¹⁴ For example, the Bank of England’s press release of 22nd March 2017 setting out the FPC’s statement from its policy meeting of that date refers to the risks of increased household indebtedness representing “a risk to lenders if accompanied by weaker underwriting standards”. The FPC propose to counter this risk, and others, using annual cyclical stress tests and countercyclical capital buffers

part of the Risk function. Each has different reporting lines and are subject to different organisational expectations.¹⁵ These issues, not normally the subject of regulatory analysis, coupled with an increasingly disconnected distribution system, indicate potential structural flaws in the regulatory model. These issues are considered in the next sections.

4.4 The origins and concepts behind UK mortgage conduct of business regulation

4.4.1 The relationship between mortgage and investment advice regulation

In order to understand the conduct of business regulation of mortgages in the UK it is necessary to understand how these regulations originated. It is important to appreciate that the conceptual structure of current mortgage regulation follows those determined as appropriate some thirty years ago to protect the clients of stockbrokers; a wholly different financial services sector. As argued later in this chapter this may not be the right approach. The concept of the trusted adviser - acting in the best interests of their client - underlies much of UK's conduct of business regulation. Its origins can be seen in the reaction to the collapse of the stockbroking firms Hedderwick Sterling and Gumbar, and Halliday Simpson in 1981 and 1982.¹⁶ These two failures revealed failings in the existing limited regulation of investment business and the inadequacy of the Prevention of Fraud (Investment) Act 1958; the only piece of regulation protecting clients at the time. Consequently, the Secretary of State for Trade and Industry, in the newly elected Conservative government, asked Professor Laurence Gower to consider what could be done to improve the regulation of investment business. The need for action was reinforced by the extensive

¹⁵ Supra note 9, (Chiu), 90-92

¹⁶ The report by Professor Gower was prompted by the failures of a number of stockbrokers and the debate in Parliament on this report largely focused on the role of stockbrokers and, to some extent, Lloyds of London (eg towards the end of the debate Anthony Nelson MP, previously a City merchant banker and asset manager and later Economic Secretary at the Treasury said "I regret that, unlike some of my colleagues, I cannot start my speech with a declaration of some enormous shareholding in a profitable firm of stockbrokers. I rise with some temerity as one of the first non-stockbrokers to speak from the Conservative Benches.", Hansard, HC Deb, 16th July 1984, Vol. 64, 49-114, 87). The subsequent structure of the rules envisaged the client meeting and discussing their affairs with a trusted investment adviser (supra note 5). The initial regulatory framework was based on a "self-regulatory" model with a regulatory "club" of investment advisers devising their own rules, within limits and subject to independent review, and applying these rules to its members using contract law

fraudulent activities of the investment business of Barlow Clowes which came to light in 1987. In Gower's final report in 1984, he outlined a "transactional model" for regulating investment business.¹⁷ In Gower's opinion "regulation should be no greater than is necessary to protect reasonable people from being made fools of".¹⁸ Caveat emptor would be replaced by adequate disclosure and reliance on trusted advisers backed by monitoring and enforcement under a new regulatory structure. Gower was, however, clear that "regulation should not seek to achieve the impossible".¹⁹ In his view "the task of regulation was not to protect fools from their own folly."²⁰ However, as will be explored in the next section, the proposed model for regulating the financial services was narrowly drawn and was based on what I term the "trusted investment adviser" concept.

4.4.2 Path-Dependency of mortgage conduct of business regulation

There are a number of types of path-dependency.²¹ This thesis focuses on rules-driven path dependence where initial structures determine legal rules which in turn determine subsequent arrangements. It is possible that these subsequent developments may not be efficient but as a result of sunk cost, costs of switching or change may not be cost effective. Change may also not occur due to the actions of those who want to maintain "rent-seeking" embedded in the existing structures and interest group politics. All this results in an "imperfect Coasian world".²² It can also be due to simple "habit" where simple lassitude inhibits change or pride and insularity which rejects innovations that were "not invented here". There is also the old civil service rationale of wanting to avoid change since it may increase risk and that it may be safer to retain what is known.²³ The importance of these behavioural and institutional factors should not be ignored. Policymakers are very conscious of the effect of unintended consequences and the need

¹⁷ Mads Andenas and Iris Chiu, *The foundations and future of financial regulation*, (Routledge, London, 2013), 22

¹⁸ Laurence Gower, *Review of Investor Protection: Report, Part 1*, (H M Stationery Office, London, Cmnd 9125, 1984), 6

¹⁹ Ibid, (Gower), 6

²⁰ Ibid, (Gower), 7

²¹ Lucian Bebchuk and Mark Roe, 'A theory of path dependence in corporate ownership and governance' in Jeffrey Gordon and Mark Roe (eds), *Convergence and persistence in corporate governance*, (Cambridge University Press, Cambridge, 2004), 68

²² Ibid, 71

²³ Supra, note 4, (David and Arthur)

for what has been described as the “short-sightedness of evolution” where the rationality of risk-aversion out-paces innovation.²⁴ For these reasons rules established to govern investment conduct of business largely formalised existing industry structures.²⁵ As will be discussed later, statutory conduct of business regulation of mortgages followed a similar path. As mentioned above, there are many reasons for this. No single factor dominated other than an “endowment effect”, (ie the need to protect existing large players in the market by avoiding too much disruption).²⁶ How this influenced the development of investment business, and hence mortgage, conduct of business regulation in the UK is considered next.

It is clear that in the 1984 Parliamentary debate on the Gower Report, the proposed regulations were to be aimed at a narrow group of the public who could afford the services of stockbrokers and investment managers and it appears that most of the speakers in the Commons debate had either been stockbrokers or had close family who were stockbrokers.²⁷ The subsequent structure for the regulation of conduct of business largely followed the pattern set out by Gower. It revolved around a series of transactions between the client and the regulated firm: the style and content of marketing and disclosure material, the provision of “suitable advice” by honest and competent advisers who had a duty imposed on them to act in the best interests of their clients, how the investment was cared for on behalf of the client and, if matters went wrong, a process for addressing client complaints.

It is this high cost approach that was used, subsequently, as the model for conduct of business mortgage regulation affecting a much wider section of society. This model may be appropriate for a financial services business which foresees a long-term “transactional” relationship, for example, in personal banking or asset management. However, mortgages are largely “commodity” products and often processed by the computer systems of lenders

²⁴ Supra note 4, (Schmidt and Spindler), 119

²⁵ Supra note 7, (Jebens), 8

²⁶ Lucian Bebchuk and Mark Roe, ‘A theory of path dependence in corporate ownership and governance’, (1999) Stanford Law Review Vol. 52, No. 1, 127, 141

²⁷ Supra note 16, (Commons debate, 16th July 1984), 49-114

with little actual human contact or intervention.²⁸ Consequently, a regulatory approach designed with, for example, a stockbroker or private banker in mind, may not be appropriate for the mortgage “mass market”.²⁹

Conduct of business regulation is designed to clarify the distinction between those whose role it is to advise customers and businesses which provide financial products.³⁰ It is possible to view it in class terms with the professional adviser using their skill to select the appropriate financial products provided by the “financial tradesman”, particularly bankers, who manufacture them.³¹ For example, stockbroking, with the right cultural background, was an acceptable profession for a gentleman.³² The barrister and financial adviser were much higher up the social scale than, for example, the solicitor and certainly well above the commercial banker. This was especially true since much of the banking and insurance industry in England has its origins in the trade of goldsmiths and foreign exchange dealers largely established and run by non-conformists and foreigners and mutual societies based around skilled trades and self-help associations.³³ The socially acceptable professional used their professional skill and vocation to advise their clients and did not deal with money, “the scale of professional prestige was largely determined by distance from

²⁸ The term “commodity product” in this context refers to those financial products that cannot be differentiated other than by price. Typically firms will try to make their products “special” using marketing, branding and other non-price factors. The objective is to have products which are protected from fierce competition and can command higher margins. Mortgages are generally commoditised products dominated by their price

²⁹ Financial services firm, and other types of business, will attempt to segment customers into different categories in order to match costs and income. This can range from private banking and bespoke high-value lending (eg the “black credit card”) and asset management to more “mass-market” products and services with lower costs and charges. As explained above mortgages, for the most part, are commoditised products and available to all who can satisfy the credit and affordability assessments mentioned later

³⁰ For example, the distinction is maintained in the FCA Handbook in which the major division is between “Conduct of Business” (COBS) regulation largely governing financial advice and information disclosure and the “Client Assets” (CASS) rules designed to protect client money from mis-use

³¹ The economist Sir William Petty, spoke of the “trade of banking”, *Collected Works of William Petty*, (published 1899, Charles Henry Hull (ed) as the *Collected economic writings of Sir William Petty*, Terrance Hutchinson (ed), Routledge, London, 1997), Vol. II, 447

³² David Ward, ‘The public schools and industry in Britain after 1870’, (1967) *Journal of Contemporary History*, 37, 46, notes that before the First World War the “acceptable” future professions for boys from, for example, the great public school, Wellington were the military, clergy, civil service, academia, teaching and stockbroking. Banking and insurance were not mentioned

³³ Chapt 2, n80, (*Overend and Gurney*), 44-55

flagrant ‘money grubbing’”.³⁴ Professionals keeping their own house in order was the underlying concept behind the Gower Report, the subsequent Parliamentary debate and the self-regulatory system enshrined in the Financial Services Act 1986.

As mentioned earlier this view of how financials services are, or should be structured, has been applied by regulation to the mortgage market. Consequently, how the latter is structured has influenced, and in turn been influenced by, conduct of business regulation.³⁵ This context is important and is considered in the next section.

4.4.3 The development of UK conduct of business mortgage regulation

This section sets out the legislative and regulatory background to the development of UK conduct of business mortgage regulation. Key factors influencing this were: the malign effects of the recession in the early 1990s on house prices and interest rates coupled with the mis-use of a number of financial products by insurance companies, banks, building societies and various financial advisers in the late 1980s and early 1990s.³⁶ It is arguable that the UK recession in the early 1990s had a greater effect on the general population compared with the much milder recession of 2007/8. The former had a significant effect on unemployment and, consequently, on housing with high levels of both “negative equity” (where the amount outstanding on the mortgage exceeded the value of the property and made selling the home to pay off the mortgage an impossible option) and

³⁴ Martin Wiener, *English culture and the decline of the industrial spirit, 1850-1980*, (published 1981, 2nd ed, Cambridge University Press, Cambridge, 2004), 15, 14-16

³⁵ For example prior to the introduction of conduct of business regulation it was often unclear who financial advisers represented. In almost all the instances they were creatures of the asset manager, insurance company or bank with few duties owed to the customer. Conduct of business regulation placed specific requirements on the adviser in order to protect customers. In the realm of investment business RDR has had the effect of changing the structure of the industry with the cost and risks of regulation resulting in the number of advisers falling (from over 40,000 in 2011 before the regulation came into force to just over 30,000 in 2014) as banks exited the advice market. The market is now dominated by independent financial advisers who largely restrict their business to high-net-worth customers reflecting this cost and risk effect, (HM Treasury and FCA, ‘Financial advice market review: final report’, (March 2016), 18-20). The report contains recommendations to try to amend the regulations to reverse this effect (eg by encouraging the development of automated “robo” advice for the mass market, 27-30). There are similar developments in the mortgage advice market, (FCA, ‘Embedding the mortgage market review: advice and distribution: thematic review’, (July 2015), TR15/9, 31-34)

³⁶ Matthew Watson, ‘Constituting monetary conservatives via the ‘savings habit’: New Labour and the British housing market bubble’, (2008) *Comparative European Politics*, 6, 285-304, 295-296. See also Christopher Gentle, Daniel Dorling and James Cornford, ‘Negative equity and British housing in the 1990s: cause and effect’, (1994) *Urban Studies*, Vol. 31, No. 2, 181-199, 185-186

home repossessions.³⁷ In total there were 340,500 repossessions between 2008 and 2012. This was substantively much lower than 556,300 repossessions during the earlier crisis between 1990 and 1994.³⁸

The housing and unemployment problems during the crisis in the early 1990s were exacerbated by the practices of many of the trusted investment advisers. They had developed new ranges of investment products in the 1980s and early 1990s and coupled these with mortgage lending. These took two main forms: mortgage endowment policies (“MEPs”) and home income plans (“HIPs”). MEPs involved the adviser using a life insurance equity based investment product known as an “endowment policy”, which for part of the 1980s was subsidised through the tax system, and an interest only mortgage. The customer only paid the interest on the mortgage and the insurance premiums. The scheme involved the insurance investment policy maturing at the same time as the mortgage had to be repaid and rested on the proceeds of the redemption of the investment policy being sufficient to pay off the mortgage. The products were often sold on the basis that even after the mortgage had been repaid there might be a surplus for the customer. The HIP was designed for older customers who borrowed against the equity in their home and invest some of, or all, the proceeds of a remortgage in an investment product. The mortgage interest was rolled up and the proceeds of the sale of the investment policy would be available to pay off the mortgage and the accrued interest on the death of the mortgagee/investor. This product was sometimes known as a “lifetime” or “equity release” mortgage. However, each of these types of product involved a gamble, which in most cases failed, on interest rates, equity growth and the health of the general economy.

Due to high interest rates, a fall in equity values in 1987 and in the recession in the early 1990s customers were unable to repay their mortgages and homes were repossessed. Customers had difficulty holding anyone responsible because the financial advisers, regulated under the Financial Services Act 1986, often turned out to be “men of straw” with no, or insufficient, assets and the investors compensation scheme limits were too low to help. The mortgage lenders were not subject to conduct of business regulation. Some

³⁷ Over 70,000 properties were repossessed in the UK in each of the years 1991 and 1992 (0.75% of all mortgages) compared to just over 40,000 in each of years 2009 and 2010 (0.38%), Library of the House of Commons, ‘Repossessions and mortgage arrears: statistics’, (February 2011), SN/SG/0263

³⁸ Ibid, (House of Commons Library), 5

legal actions against lenders were successful but only after the cases had been pursued through to the House of Lords.³⁹ Consequently, political and consumer groups called for investment business regulation to be extended to include mortgages sales. The issue was taken up by the Labour Party and its 1997 election manifesto proposed to introduce mortgage conduct of business regulation. The new government also started the process of dismantling the existing regulatory structure and combining a range of regulatory bodies covering both prudential and conduct of business regulation into a single regulator: the Financial Services Authority (FSA). The approach taken by the new regulator and the lending industry's response are considered next.

4.4.4 The response by the lending industry and the cautious approach by the new regulator

In an attempt to pre-empt detailed regulation of the mortgage distribution conduct of business, in 1996, the Council of Mortgage Lenders (CML), a trade body, developed and implemented a voluntary code of practice, based on the investment business regulatory model, known as the "Mortgage Code" for the mortgage industry.⁴⁰ It was an important development since much that was contained in this Code was subsequently transposed into the final regulations that came into force in 2004. Following Labour's election victory in 1997, HM Treasury launched the first regulation of mortgages consultation in July 1999.⁴¹ This proposal was also mentioned in the Treasury consultation paper on creating the FSA.⁴² The new FSA issued a cost-benefit analysis for mortgage regulation in October 1999.⁴³ The Treasury undertook a further consultation before it issued a Regulated Activities Order (RAO) in February 2001 covering pre-sale mortgage information. However,

³⁹ For example, *Investors Compensation Scheme v. West Bromwich Building Society*, House of Lords, 19th June 1997, Session 1997-98, 1All ER 98 [1998]

⁴⁰ Michael Coogan, Director General, Council of Mortgage Lenders, 'Recent developments in the UK housing and mortgage market', (Housing Finance International, March 1998)

⁴¹ H M Treasury, 'Regulation of mortgages, a discussion document', (July 1999)

⁴² H M Treasury, 'Financial Services and Markets Bill: A Consultation Document, overview of financial regulatory reform', (July 1998)

⁴³ FSA, 'A cost-benefit analysis of statutory regulation of mortgage advice', (October 1999)

in deference to the industry's Mortgage Code of 1996, mentioned above, the Order did not include mortgage advice, which was left subject to the CML's Mortgage Code.⁴⁴

How regulation would be implemented was set out, at a high level, in the FSA's Consultation Paper (CP) 70 in November 2000 followed by more detailed proposals in CP 98 in July 2001.⁴⁵ The regulations mirrored those for investment business and were based on a number of broad areas including the FSA's high level principles (eg treating customers fairly, transparency with the regulator, adequate systems of control, which were largely carried over from the previous regulatory regime established by the Financial Services Act 1986), providing information to customers, training and competence of staff etc. This approach was consistent with the concept of "transaction regulation", which as mentioned earlier, conceptually envisaged conduct of business regulation as encompassing a series of interactions between customers and their trusted advisers and the firms that employed them or they represented. Nevertheless, conduct of business mortgage regulation was a new challenge for the FSA and, as will be considered next, its response was uncertain.

4.4.5 FSA concerns and its "diffident" approach

The FSA remained uncertain how to regulate mortgage conduct of business and expressed concern about the effect of regulation on the mortgage market. Nevertheless, as explained earlier, there were certainly issues with business practices. In their 2000 consultation the FSA explained its own two-fold concern: that they had found evidence of consumer detriment in the mortgage market based on the sale of endowment insurance policies alongside mortgages.⁴⁶ The FSA equivocated about whether the adequacy of the borrower's security should be a sufficient basis on which to lend.⁴⁷ However, the FSA appeared to conclude that "... it is not prudent to lend on the basis of security alone" and that the FSA needed to reflect its "Principle 6" (the need to "pay due regard to the interests

⁴⁴ H M Treasury, 'Regulating mortgages', (October 2000); H M Treasury, 'Response to the Consultation Paper: regulating mortgages, October 2000', (February 2001)

⁴⁵ FSA, 'Mortgage regulation: The FSA's high level approach', (CP 70), (November 2000), and 'The Draft Mortgage Sourcebook, including policy statement on CP70 (CP98)', (July 2001)

⁴⁶ Ibid, (CP70), 4. See also, for example, FSA's enforcement action against Abbey life Insurance (part of Lloyds Bank) for mis-selling mortgage endowment policies between 1995 and 1999, (2002)

⁴⁷ Supra note 45, (CP 70), 24

of its customers and treat them fairly”).⁴⁸ However, the FSA saw that it was important to “strike a balance when considering Principle 6. ... [since] any restrictions to lending practices introduced by the FSA may simply limit access to the mortgage market.”⁴⁹ Conversely, the FSA were concerned that without some restrictions lenders might “exploit consumers by lending in circumstances where it is self-evident that they would be unable to repay through income.”⁵⁰

It is worth contrasting this approach with the regulatory stance some nine years later where the regulator, and regulation, took a much more “dirigiste” form adopted by the MMR and Mortgage Conduct of Business section of the FCA rule-book. In the early 2000s the FSA was content to regulate with a mixture of industry “self-regulation”, under the auspices of the CML Mortgage Code, mentioned earlier, buttressed by limited FSA rules. The FSA’s ambivalence was shortly afterwards altered by EU action which sought to bring “intermediation activities” within the scope of financial services regulation. This formed part of the EU Commission’s strategy to develop a single market in financial services. The consequence, as will be seen next, was to incorporate the Mortgage Code within the FSA’s own regulations.

4.4.6 The end of “self-regulation” and the move to a solely statutory based regulatory regime

As mentioned above, there was a change of plan and timetable with the proposed EU Insurance Intermediaries Directive which widened regulation to include advice and intermediary regulation.⁵¹ As a result the effective date for mortgage regulation was set back to October 2004. The FSA consultation in August 2002 (CP 146) set out its revised plans to regulate the mortgage advice process and advisers who would be subject to the

⁴⁸ Supra note 45, (CP 70), 24. It is worth noting that the Office of Fair Trading had carried out its own review in 1995 on mortgage advice and concluded by simply publishing a guidance leaflet for consumers, ‘Annual report of the Director of Fair Trading’, (1995), 16. See also House of Commons Library, ‘Endowment mortgages’, (8th June 2015), Briefing Paper 570

⁴⁹ Supra note 45, (CP 70), 24

⁵⁰ Supra note 45, (CP 70), 24

⁵¹ Insurance Mediation Directive 2002/92/EC of the European Parliament and Council (9th December 2002) Official Journal L 009, 15/01/2003 P. 0003 - 0010

new regulations.⁵² The regulation of investment advice remained the model. The Feedback Statement on the consultation's draft rules appeared in May 2003 (CP 186).⁵³ Final rules known as "MCOB" were published in October 2003. Much of the debate at the time was focused on mortgage disclosure requirements and adapting the path-dependent approach for investment business for mortgage distribution.⁵⁴

The 2003 rules, which came into force in October 2004, required the mortgage adviser to advise the customer "which mortgage contract will be suitable...[and] to have reasonable grounds to conclude that the customer can afford to enter into the [mortgage contract and that it] is appropriate to the needs and circumstances of the customer".⁵⁵ As part of the affordability assessment the adviser should "give due regard" to the "information the customer provides about his income and expenditure and any other resources ... any likely changes" to these areas and any increase in interest charges after the initial mortgage introductory offer expires.⁵⁶ As already mentioned the rules are a mirror of those relating to investment business. Shortly after the new rules came into effect the FSA carried out a series of reviews, the results of which, combined with the start of the financial crisis led to a regulatory change of policy. These changes are considered in the next section.

4.4.7 The financial crisis and the effect on mortgage conduct of business regulation

This section considers the FSA's new approach and the origins of its Mortgage Market Review (MMR). The FSA acted quickly after the new regulations came into force to assess how they had been implemented. To an extent these reviews were overtaken by the start of the financial crisis. The FSA, under new leadership adopted a much more assertive

⁵² FSA, 'Approach to regulating mortgage sales', (2002), CP 146

⁵³ FSA, 'Mortgage regulation: draft conduct of business rules and feedback on CP146', (2003), CP 186,

⁵⁴ Kevin Littler and Robert Hudson, 'The impact of regulatory change on retail financial product distribution in the UK', (2003) 11(1), *Journal of Financial Regulation and Compliance*, 76

⁵⁵ Rule 4.5.4, (CP146), *supra*, note 53

⁵⁶ 4.5.7 Evidential section, (CP 146), *supra*, note 53

tone.⁵⁷ There was a FSA thematic review of the implementation of the new regime in 2005 which was published in 2006 as part of “phase 1”. This was focused on disclosure, advice and selling standards in the prime mortgage market. However, the “phase 2” review, which looked at higher risk areas, was more influential since it straddled the start of the financial crisis, with the review starting in April 2007 and reporting in March 2008.⁵⁸ As a result of this, and deficiencies revealed by the financial crisis, the FSA launched its MMR in May 2009.⁵⁹

The FSA considered that a review was necessary since they believed that potential consumer detriment existed since consumer incomes were not verified in 49% of mortgage applications and 32% of mortgages were provided on an interest only basis.⁶⁰ The FSA’s view was that it was only the existence of low interest rates and lender forbearance that had prevented problems crystalising.⁶¹ The new rules placed responsibility for ensuring the suitability and affordability of the mortgage solely on the lender no matter who provided the mortgage advice; affordability had to be evidenced and documented; the effective banning of interest only mortgages and specifying what factors needed to be taken into account in determining affordability. The FSA briefly considered adopting other paths to mortgage regulation. Its 2009 consultation considered the use of higher capital requirements to constrain mortgage lending but concluded that “... increasing capital requirements would not be an effective mechanism for deterring high-risk lending and that using prudential levers to achieve objectives relating to consumer detriment is subject to significant uncertainty.”⁶² The FSA also considered applying LTV, DTI and loan to income (LTI) ratios but conclude that “capping ratios is a blunt approach...it would lead to a reduction in access to credit for some people able to afford high LTVs but not having access to means

⁵⁷ Hector Sants became chief executive officer in July 2007. The change in style is clearly stated in his speech, ‘Delivering intensive supervision and credible deterrence’, “There is a view that people are not frightened of the FSA. I can assure you that this is a view I am determined to correct. People should be very frightened of the FSA...The FSA has been seared by recent events but it is tougher and better as a result.”, at the Reuters Newsmakers event, 12th March 2009

⁵⁸ FSA, ‘Mortgage effectiveness review: stage 2 report’, (March 2008)

⁵⁹ Supra note 1, (Discussion paper: Mortgage Market Review ,2009)

⁶⁰ Ibid, 20

⁶¹ FSA, ‘Mortgage Market Review’, (December 2011), CP 11/31, 15

⁶² Supra note 1, (Discussion Paper, Mortgage Market Review, (2009), 9 and 30 - 31. It is worth noting that the Financial Policy Committee has imposed LTV restrictions on high debt to income mortgages (Bank of England, ‘CP11/14 Implementing the Financial Policy Committee’s recommendation on loan to income ratios in mortgage lending’, (June 2014)

(such as parental support) by which others may afford high deposits.”⁶³ However, a form of product regulation was developed as a possible way forward but only to be used in a number of limited circumstances. These included prohibiting high LTV loans to those customers who display a number of “high risk factors” such as “credit impaired borrowers who have an unstable income or other “toxic” mixes.”⁶⁴

4.4.8 Borrowers not properly advised

According to the FSA’s own information in 2007 about 1.9% of mortgages, by number, were made to those who were “credit impaired” and just over 14% were made to those whose future income may be irregular or “unstable”.⁶⁵ The FSA was also concerned that products designed for the self-employed, where the borrower “self-certified” their income, were being abused and that this type of lending should be prohibited.⁶⁶ More generally, the FSA’s key issue was the “lack of proper affordability assessments”.⁶⁷ Specifically, the FSA’s concern was that customers were not being properly advised as this required a full “affordability and appropriateness” assessment for all mortgage sales.⁶⁸

⁶³ Supra note 1, (MMR 09/3) 11 and 37-44. It is worth noting that the FPC has recently been granted powers to set LTV and LTI limits as part of its macroprudential set of “tools”, (The Bank of England Act 1998 (Macroprudential Measures) Order 2015

⁶⁴ Supra note 1, (MMR 09/3), 12

⁶⁵ Supra note 1, (MMR 09/3), 46

⁶⁶ Supra note 1, (MMR 09/3), 12. FSA thematic work found many examples where brokers had not been able to justify recommending a “self-certified” mortgage. There were also widespread cases of failures demonstrate customer mortgage affordability: ‘FSA mortgage regulation - one year on’, Callum McCarthy, Chairman of the FSA, speech to the Council of Mortgage Lenders Annual Conference, 6th December 2005

⁶⁷ Supra, note 1, (MMR 09/3), 12

⁶⁸ Supra note 1, (MMR 09/3), 62. It is possible that the regulatory focus on lenders is deliberate so as to enable the FCA to use its resources more efficiently on a small number of large lenders rather than several thousand mortgage brokers

4.5 The main elements of the new regulations in relation to mortgage “affordability”

4.5.1 The issue of who should be responsible for assessing the ability of customers to afford a mortgage

The intermediaries are also subject to regulation and are authorised and supervised by the FSA/FCA. However, “to remove any uncertainty about the respective responsibilities of lenders and intermediaries” the regulations were amended to place on the lender “ultimate responsibility for assessing and verifying affordability in every sale.”⁶⁹ Consequently, the borrower would need to meet the intermediary face-to-face and provide information on their income, spending and prospective outgoings together with documentary evidence. The intermediary would, in due course, pass all this information to the lender for the latter to carry out a full affordability assessment.⁷⁰ It is pertinent to consider, in more detail, how the regulator expected this to be undertaken.

4.5.2 Verifying income and expenditure

The requirements for verifying income and spending, both current and future, were very prescriptive with some three layers of calculation and evidence.⁷¹ The expenditure “can be verified against publicly available sources (eg level of income tax and national insurance) or documentation provided by a consumer (eg bank account statements and [utility bills]) ... or accept consumer provided data (eg food expenses).”⁷² “Some of this data can be checked against national averages [using Office of National Statistics information] so that any non-credible outliers can be identified and investigated.”⁷³ The result of all of this,

⁶⁹ Supra, note 1, (MMR 09/3), 63. Although not discussed by the FSA in their MMR papers there may be acceptable technology methods to assess and verify income and expenditure using, for example, authenticated tax record filings and models based on Office of National Statistics (ONS) and in-house lender data. The former would require approval by the UK tax authorities and both approaches would need to be acceptable to the FCA

⁷⁰ Supra, note 1, (MMR 09/3), 63

⁷¹ Supra, note 1, (MMR 09/3), 53

⁷² Supra, note 1, (MMR 09/3), 55

⁷³ Supra, note 1, (MMR 09/3), 55

and the requirements to provide advice, was to place the process firmly back in the hands of a “trusted adviser”.

4.5.3 New Regulations come into effect in April 2014: a summary

The FSA was replaced by the Financial Conduct Authority in April 2013. As mentioned, the draft rules went through a number of consultations before the final rules were issued in December 2012, coming into effect in April 2014.⁷⁴ The MMR 2012 rules were designed as “anticipatory regulation”.⁷⁵ The objective of the 2012 rules is to prevent a future crisis.⁷⁶ Although the approach became more paternalistic it, nevertheless, continued to reinforce the concept of the “trusted adviser”. The approach is “paternalistic” in that, for behavioural reasons, the FCA considers that borrowers are generally not able to take care of their own interests. This subject is considered in more detail later in this chapter. The regulatory view that borrowers are largely myopic and unengaged is addressed by requiring them to consult a “trusted adviser” before entering into a mortgage contract.

As mentioned earlier, the FSA issued its final MMR Policy Statement and Rules in October 2012.⁷⁷ Much of the Policy Statement was concerned with areas such as the definition of “advice”, the ability of high-net-worth customer to opt-out of the affordability assessment requirements and the application of the rules to business customers. The regulations also included mandating the provision of advice to customers to be provided either face-to-face or over the telephone. Allowing customers to proceed without advice (ie “execution only”) was largely restricted to mortgages arranged over the internet.

There were also new prudential requirements for non-deposit taker mortgage lenders and new rules for arrears management and forbearance. The key rules on assessing the affordability, repayability and suitability of the loan are set out in sections 11.5 - 11.7 of the new Mortgage Conduct of Business (“MCOB”) rules.⁷⁸ These restrict the provision of interest only mortgages by requiring that the consumer has a repayment strategy and that

⁷⁴ FSA, ‘Policy Statement 12/16 Mortgage Market Review Feedback on CP11/31 and final rules’

⁷⁵ Chapt 3, n69, (Harris, “Anticipatory regulation’), 38

⁷⁶ Supra, note 1, (MMR 09/3), 22

⁷⁷ Supra, note 74, (‘MMR Policy Statement’)

⁷⁸ FCA, *‘Mortgage Conduct Of Business Rules’*, (MCOB) 11.5-7

this is evidenced.⁷⁹ There are detailed rules regarding the need for the lender to be able to demonstrate that the customer is able to afford the mortgage. This needs to be based on verified income from a source other than the customer (eg from tax returns, payslips etc).⁸⁰ The customer's level of expenditure must be ascertained and analysed into committed and basic essential expenditure (eg food, washing, utility payments) and basic quality of living costs which are "hard to reduce and [give] a basic quality of life" (eg holidays, entertainment).⁸¹ The lender also needs to consider potential changes in income and expenditure (eg planning a family or retirement date).⁸² It is interesting to note recent anecdotal reports on potential borrowers suppressing information to avoid problems with the new affordability calculations.⁸³ The latter need to include a future interest rise stress test over at least the first five years of the loan.⁸⁴ The new rules place responsibility on the board of the lender to set policies and to arrange for the monitoring of, and reporting on, a range of these detailed policies relating to mortgage affordability.⁸⁵ These policies need to include:

- “(a) details of the types of income which are acceptable;
- (b) the proportion of different income streams which is acceptable;
- (c) how variations in income over time, of which the firm is aware, are to be considered;
- (d) what is acceptable evidence of income (including the time period to be covered by the evidence); and
- (e) how committed expenditure, basic essential expenditure and basic quality-of-living costs are taken into account when assessing affordability;

⁷⁹ Ibid, 11.6

⁸⁰ Supra note 78, 11.6-8

⁸¹ Supra note 78, 11.6.10

⁸² Supra note 78, 11.6.14-15

⁸³ Business Reporter, *'Many young female home-buyers 'hide family plans from mortgage lenders'*, (8th October 2015), "A survey from uSwitch.com among more than 2,000 women aged 25 to 45 who had applied for a mortgage found that 25% had intentionally kept their family plans from lenders in case they missed out on the best mortgage rate or were rejected." Daily Telegraph, *'How borrowers are tricking mortgage lenders'*, (5th December 2015), "Prospective mortgage borrowers are resorting to desperate measures to hide their personal spending in an effort to pass lenders' tough affordability checks, according to new research [by MoneySuperMarket]. One in five of those planning to apply for a mortgage in the next three years is planning to withdraw and spend cash rather than use credit or debit cards so that lenders can't see what they spend their money on"

⁸⁴ Supra, note 78, 11.6.18

⁸⁵ Supra, note 78, 11.6.20

- (f) how future interest rates are taken into account when assessing affordability;
- (g) the calculations used to determine whether the... mortgage is affordable;”⁸⁶

The board of the lender is required to have an independent monitoring and reporting programme in place usually undertaken by the firm’s Compliance or Internal Audit functions, which have their own responsibilities and regulatory accountabilities.⁸⁷ This is part of a wider series of regulatory actions to increase board and individual accountability in regulated firms.⁸⁸ There are extensive evidential record keeping requirements which may be used by the FCA’s supervision teams for their own monitoring of lenders and in referrals to the FCA’s Enforcement Division.⁸⁹

The rules place particular importance on the ability of the lender to be able to demonstrate the affordability of the mortgage after the borrower has reached retirement.⁹⁰ It is important to note the FCA’s guidance since it is very specific and has attracted significant criticism during the consultation process and subsequently. It states that: “If the term [of the mortgage] would extend beyond the date on which the customer expects to retire (or, where that date is not known, the state pension age), a firm should take a prudent and proportionate approach to assessing the customer’s income beyond that date. The degree of scrutiny to be adopted may vary according to the period of time remaining to retirement when the assessment is made. The closer the customer is to retiring, the more robust the evidence of the level of income in retirement should be. For example, where retirement is many years in the future, it may be sufficient merely to confirm the existence of some pension provision for the customer by requesting evidence such as a pension statement; where the customer is close to retirement, the more robust steps may involve considering expected pension income from a pension statement”.⁹¹ The result is that it may be very difficult for a lender to provide a mortgage which extends into a borrowers’ retirement.⁹²

⁸⁶ Supra, note 78, 11.6.20

⁸⁷ Supra, note 78, 11.6.22-24

⁸⁸ FCA, ‘Consultation Paper 15/22 Strengthening accountability in banking’, (July 2015)

⁸⁹ Supra, note 78, 11.6.60-61

⁹⁰ Supra, note 78, 11.6.15

⁹¹ Supra, note 78, 11.6.15(2)

⁹² Daily Telegraph, ‘*Forty-somethings ‘too old to get a mortgage’*’, (11th July 2014)

4.6. Mortgage regulation: key issues

4.6.1 The FCA's assessment of the consequences

As already mentioned, the rules place all the responsibility on the lender for assessing the affordability of the mortgage.⁹³ There is no regulatory responsibility placed on the intermediary mortgage adviser to undertake this assessment. In other respects the new requirements are very similar to previous rules. However, they are set out in much greater detail and are expressed in more prescriptive terms. As mentioned above, areas such as interest only mortgages, which were typically used by first time buyers, are effectively banned. The same applies to “self-certification” mortgages (where the borrower states their income and this is not verified objectively) which may have encouraged some consumers to over-inflate their incomes, and are now also prohibited. As part of their cost-benefit assessment the FSA estimated that only some 2% of affordable mortgages, in a depressed property market, and 11%, in a booming market, would now be declined under the new rules.⁹⁴

4.6.2 Who may be affected by the MMR regulations

The FSA considered this effect on those who could afford a mortgage is an acceptable consequence of the new regulations.⁹⁵ However, there is anecdotal evidence from some lenders that the adverse effect on “good” consumers is much higher and much more significant. The FSA stated that the effect on prime borrowers would be close to zero.⁹⁶ However this fails to take account of the likely impact on mortgages, which run beyond the consumer's likely retirement date and the effect of income verification, particularly on the self-employed. The FSA considered that most of those affected will be interest only borrowers who use this type of loan to enter the housing market and who later switch to a repayment mortgage as their household income increases as they advance in their

⁹³ Supra, note 78, 11.6.1

⁹⁴ Supra, note 74, FSA, ‘Mortgage Market Review’, (December 2011), CP 11/31, A3:1

⁹⁵ Supra, note 74, A1 27-28

⁹⁶ Supra, note 74, A1:25 and A1: 42

careers.⁹⁷ Certainly consumer mortgage application interviews have lengthened to over three hours or more and they have become much more intrusive in terms of their personal questions and information requirements.⁹⁸ This is emphasised in the next section on the implications of “giving advice”.

4.6.3 The long term implications of “giving advice”

Compliance with the regulations will be assessed by the FCA's monitoring teams who are required to exercise their judgment in determining whether the lender has met both the letter of the rules and the spirit of the FCA's Principles. There is considerable fear among lenders how this judgment will be exercised and this is acknowledged by the FCA.⁹⁹ The concern of lenders is reinforced by the potential cost of not achieving the right standard. The cost of restitution would certainly dwarf any regulatory fine. The “trusted adviser” is required to understand the needs of the customer and to provide “suitable advice”. If the adviser fails in this regulatory duty they expose themselves to a claim for compensation. The standard basis for this is calculated on the cost of putting the customer back in the position they would have been in if the investment had not been made and includes an element for “loss of opportunity”.¹⁰⁰ With loans of tens of thousands of pounds covering long-term contracts the lender could be required to reduce the outstanding balance or the interest rate or both to ensure that the mortgage is affordable.¹⁰¹ Spread over many thousands of mortgages this has the potential to threaten the financial soundness of the lender. Of course the PRA has the power to direct the FCA to refrain from taking any action, which the PRA believe may “threaten the stability of the UK financial system, or result in the failure of a PRA authorised person in a way that would adversely affect the UK financial system.”¹⁰²

⁹⁷ Supra, note 74, A1:54-62

⁹⁸ The Guardian, ‘*Applying for a mortgage? Prepare for the third degree*’, (1st June 2014)

⁹⁹ Supra, note 74, (FSA, ‘MMR Policy statement and feedback on CP11/31’)

¹⁰⁰ Financial Ombudsman Service, ‘On-line Technical Resource: Compensation for being “deprived” of money and for investment loss’

¹⁰¹ The Financial Ombudsman Service reported in 2014 the largest increase in mortgage related complaints (13,659 in 2013/14 compared to 12,845 in 2012/13. These mainly related to problems involving financial difficulties. See also a successful compensation claim reported in the The Guardian, ‘Key repossession ruling opens door to mortgage mis-selling complaints’, (22nd March 2009)

¹⁰² s31, Financial Services Act 2012

The degree of input by the FCA into the deliberations of the PRA and FPC appears to be limited and it is not clear that conduct of business matters impinge over-much on the PRA's concept of prudential regulation.¹⁰³ This is unfortunate since the FCA will have information which may be relevant to the prudential regulator concerning, for example, ethics and culture within dual-regulated firms and insights into business models. In all the many mis-selling scandals (eg mortgage endowments, pension opt-out and transfers, split capital investments, payment protection insurance etc) none have threatened the failure of a systemically important firm. However, it is possible, for the reasons described above, that a major mortgage mis-selling problem relating to mortgage affordability may threaten one or more such firms. It is an aspect which does not appear to have been the subject of much prudential regulatory, industry or political concern.

4.6.4 The effect of EU Mortgage Credit Directive on the MMR

It is worth noting that in parallel to the MMR, the EU Commission developed its own Mortgage Credit Directive (MCD), which was implemented in the UK in 2015 and came into force on 21st March 2016.¹⁰⁴ The only significant change to UK regulation is the requirement to replace the current Key Facts Illustration (KFI) sheet with the European Standardised Information Sheet (ESIS). The FCA's view is that this latter document is much less useful for customers compared to the existing KFI. Member states are obliged to use the ESIS without amendment. However, it includes terminology that is unfamiliar in the UK (eg "exit charges" rather than "early repayment costs"). It also requires a second "annual percentage rate of charge" (APRC) calculation based on the highest level of interest rate on a product in the last twenty years which is likely to cause confusion and not be helpful. As part of the FCA's commitment to behavioural testing, the KFI was tested on a range of customers and changes made to ensure clarity and understandability before

¹⁰³ This is based on non-attributable conversations with regulatory staff

¹⁰⁴ 2014/17/EU. It has been implemented by Statutory Instrument: Mortgage Credit Directive Order 2015 and FCA rule changes, 'PS15/9: Implementation of the Mortgage Credit Directive and the new regime for second charge mortgages, feedback to CP14/20 and final rules', (March 2015)

being implemented.¹⁰⁵ The EU Commission has not carried out any such testing on the ESIS.¹⁰⁶

4.7 UK regulation, Information disclosure and behavioural economics

The original reason given for mortgage regulation in the UK, when mortgages first became regulated, was to encourage consumers to shop around for their mortgages by requiring lenders to provide standardised information which could be compared by the consumers before deciding.¹⁰⁷ However, as a result of market and regulatory changes the proportion of UK mortgages sourced from intermediaries rose from 35% in 2000 to almost 65% by 2007, with an additional 18% undertaken on an “execution only” basis by post and the internet.¹⁰⁸ The likelihood was that the consumer expected the intermediary to do the research for them and to find the best mortgage deal available. Prior to 2007, when credit was freely available, lenders would offer attractive one or two year low interest deals before the borrower moved onto higher “standard variable rate” terms.¹⁰⁹ However, borrowers, assisted by intermediaries, would move before the low rate offer expired to another lender’s low interest rate mortgage and so the process would continue. Consequently, due to high levels of competition for borrowers coupled with the growth of

¹⁰⁵ For example, ‘Smarter consumer communications, DP15/5’, Christopher Woolard, Director of Strategy and Competition, speech, 25th June 2015

¹⁰⁶ This is based on my own discussions with EU Commission staff in 2013 and confirmed by subsequent conversations with FCA staff. The EU Commission launched a Green Paper in December 2015 on ‘*Giving Europeans more choice in financial services*’ looking at the barriers to expanding cross-border retail financial services. See also speech by the then EU Commissioner, Jonathan Hill, at the European Commission’s Public Hearing on the Retail Finance Green Paper, Brussels, 2nd March 2016

¹⁰⁷ FSA: ‘Choosing a mortgage, Report of a research review and qualitative research on the mortgage buying process’, (2001), 22-23

¹⁰⁸ Supra, note 74, (FSA CP 11/31, ‘Mortgage Market Review’, December 2011), 147. The market share for mortgage brokers continues to rise and is expected to reach 75% by the end of 2016 (Mortgage Solutions (a trade paper), 28th August 2015)

¹⁰⁹ David Miles, *The UK Mortgage Market: Taking a Longer-Term View: Final report and recommendations*, (HM Treasury, London, 2004), 37, “4.41 The great majority of mortgage intermediaries’ remuneration is paid in the form of commission from the lenders to which they refer business...intermediaries have some financial incentive to sell short-term discounted products with the prospect of a resale in the near future”

mortgage intermediaries there was little incentive for consumers to spend too long shopping around nor to read mortgage disclosure material.

4.7.1 FSA research findings

This view is supported by FSA research, which found that consumers did not use disclosure documentation as expected.¹¹⁰ “Our consumer research suggests that [the] disclosure documents are not being used in the way we intended.”¹¹¹ The main disclosure document was being used by consumers “as a record of their purchase [rather] than as a tool to inform their decision on a product...[it was] only ... used to compare products by a small proportion of consumers.”¹¹² Consequently, building on this research, the FCA has reduced its faith in the effectiveness of information provided to consumers and instead placed more reliance on the role of the lender to ensure affordability.¹¹³ This approach appears to be part of a much broader regulatory strategy, which regards consumers as rarely capable of looking after their own interests. It places a duty on the adviser and lender to “act in the best interests of the consumer”.¹¹⁴ Evidence from behavioural economics does appear to support the interventionist FCA attitude which may be appropriate in this area.¹¹⁵ Indeed the FCA are looking more generally at behavioural biases in mortgage lending.¹¹⁶

4.7.2 FCA work on behavioural economics

¹¹⁰ Supra, note 74, (FSA CP 11/31, ‘Mortgage Market Review’, December 2011), 168

¹¹¹ FSA, ‘Consultation Paper 28/10: Mortgage Market Review: Distribution & Disclosure’, (November 2010), 23 and supra, note 58, (FSA Effectiveness review), 5

¹¹² Ibid, (FSA CP 28/10), 23

¹¹³ Supra, note 74, (FSA CP 11/31), 169. This is supported by research undertaken on behalf of the FCA, Oxera, ‘Review of literature on product disclosure’, (October 2014), 3-4

¹¹⁴ Supra, note 74, (FSA CP 11/31), 162

¹¹⁵ Behavioural economics, in the field of conduct of business regulation provides valuable insights. Consequently, the FCA has set up a behavioural economics team to look at how consumers actually behave and how regulatory policy should be adapted. The work on how consumers use information as mentioned in the main text is of particular relevance to mortgage conduct of business regulation (FCA’s ‘Applying behavioural economics at the Financial Conduct Authority’, (April 2013)

¹¹⁶ Speech by Linda Woodall, (Director of Mortgages and Consumer Lending at the FCA) ‘Building a common language in the mortgage market’, (November 2013)

The FCA has set up a Behavioural Economics Unit, which published its first report in 2013.¹¹⁷ The FCA now look at four sets of behavioural tools: controlling information provided to consumers, determining the methods used to distribute products, how choices are presented to consumers and banning or restricting particular products.¹¹⁸ The FCA has adopted all four sets of tools as part of their approach to regulating the mortgage market. Consequently, less emphasis is now placed simply on the provision of information to consumers. Instead, the FCA focuses on the provision of “key messages at the key points in the mortgage sales process.” and, as mentioned above, information is presented in a standard format to aid the consumer.¹¹⁹ As already mentioned, certain mortgage products such as “self-certification” mortgages have been banned. Further, FSA research indicates that consumers do not understand the distinction between being provided with information and receiving advice.¹²⁰ Consequently, the FCA MMR rules have abandoned trying to draw a regulatory distinction and all interactions with customers are now described as “giving advice”.¹²¹ This greater propensity towards “paternalistic” is considered further in the next section.

4.8 The new regulatory paternalism

4.8.1 Paternalism, politics and consumer financial regulation

UK conduct of business regulation is founded on the concept of correcting market failures.¹²² However, this technocratic approach may be viewed as somewhat disingenuous since determining regulatory policy involves making a number of “political

¹¹⁷ Supra, note 115, (‘Applying behavioural economics’), 24-25 and a speech by Martin Wheatley, former Chief Executive of the FCA, ‘The human face of regulation’, 10 April 2013

¹¹⁸ Supra, note 115, (‘Applying behavioural economics’), 43

¹¹⁹ Sheila Nicholl, (Director of Conduct Policy at FSA/FCA) speech,, ‘Developing regulatory policy on mortgages at the national, European and international Level’, 3rd November 2011

¹²⁰ Supra, note 58, (‘Mortgage Effectiveness Review’), 19-20. See also Christine Jolls and others, ‘A behavioral approach to law and economics’, (1998) 50 Stanford Law Review 1471

¹²¹ FCA, MCOB 4.7A1 and 4.8A

¹²² For example this approach is clearly set out in the FCA’s ‘Economics for effective regulation’, (2014), Occasional Paper 13, 5 and it is embedded in the FCA’s statutory strategic objective to “ensure that markets function well”, FCA, ‘Our future mission’, (October 2016), 4

judgements”.¹²³ This has developed into the FCA becoming a “surrogate citizen” deciding what level of protection to prioritise and who should be protected, in what manner and to what extent.¹²⁴ The FCA may consequently set out how much individuals can afford to spend and how much financial risk they should each be exposed to. This can be seen in the regulatory policy governing the UK mortgage systems and the latter’s exposure of consumers to high levels of debt. Jane Ball notes that individual indebtedness in the UK was 86% of GDP (by 2017 this had increased to almost 140%) compared with, for example, only 48.3% in France.¹²⁵ It may be that lenders are more likely to make a loan in the UK since it is relatively easy to evict a mortgagee. In contrast there are no mortgage eviction figures available in France.¹²⁶ The legal eviction process in France also takes account of social issues not least that someone evicted is likely to have difficulty finding even rented property to live in since eviction carries a high level of social stigma. Consequently, because of the difficulty in evicting defaulters, banks are reluctant to lend unless they can be certain that there is no risk of needing to seek an eviction order.¹²⁷

4.8.2 “Structured paternalism”

The MMR’s approach is for the regulator to take greater control of the market and to determine what is best for consumers. Sigal Ben-Porath considered this form of state paternalism, and in her evaluation quoted both Kant’s view of “paternalism” as “degrading of men” and Isaiah Berlin’s contention that paternalism always leads to some form of coercion no matter how well intentioned.¹²⁸ Ben-Porath, however, believes that the proper functioning of the state requires it to act in a “structured paternalistic” manner by allowing the individual freedom of choice within set boundaries and that discussion should focus on

¹²³ Harry McVea, ‘Financial services regulation under the the Financial Services Authority: a reassertion of the market failure thesis?’, (2005) *Cambridge Law Journal*, 64(2), 413-448, 445

¹²⁴ *Ibid*, (McVea), 445

¹²⁵ Jane Ball, ‘Using banks: the effect of national attitudes to public intervention in mortgage lending and eviction in French and English law’, (2010) *International Journal of Law in the Built Environment*, 122

¹²⁶ *Ibid*, (Ball) 125

¹²⁷ *Supra*, note 125, (Ball) 124

¹²⁸ Sigal Ben-Porath, *Tough choices: structured paternalism and the landscape of choice*, (Princeton University Press, New Jersey, 2010), 25-28

where those boundaries should be.¹²⁹ However, the UK may be moving closer to the French model with a much more paternalistic approach to protecting borrowers.

4.8.3 “Libertarian paternalism”

Libertarian paternalism aims to influence “the choices...in a way that will make choosers better off” since “in some cases individuals make inferior decisions in terms of their own welfare decisions that they would change if they had complete information, unlimited cognitive abilities, and no lack of self-control.”¹³⁰ It is based on the concept that it is right and proper for the state to act to protect the consumer from themselves and it is only a matter of deciding which are the best tools for this role in “the toolbox of libertarian paternalism.”¹³¹ This form of “soft paternalism” can include regulations which seeks to educate the borrower but still leaves them with the ultimate choice.¹³² These could take the form of procedural constraints or default choices for consumers.¹³³ However, Wright challenges this view, believing that rational lenders will always take sufficient steps to protect themselves without the need for regulatory interference.¹³⁴ However, he was writing on the cusp of the financial crisis and there is substantial evidence of lenders mispricing risk contrary to their own interests, those of their customers and the financial system in general.¹³⁵ Consequently, the approach adopted by the FCA more or less ceases to treat consumers as consenting adults and places responsibility on the lender to act as the consumers’ guardian and guarantor. This develops a form of “Coasian

¹²⁹ Ibid, 28

¹³⁰ Cass Sunstein and Richard Thaler, ‘Libertarian paternalism is not an oxymoron’, (2003) 70 University of Chicago Law Review 1159

¹³¹ Ibid, (Sunstein) 1174, From the examples given by the authors the approach adopted for mortgage advice, by the FCA, lacks the “libertarian” element they envisaged. The authors consider that the “bounded rationality” of people means that in some instances a form of “guiding” or “nudge” is necessary. People, generally, are not the rational calculating machines of classical economic theory. Herbert Simon (a Nobel economics prize-winner) first coined the phrase “bounded rationality” to describe “Man, faced with complexity beyond his ken, uses his information processing capacities to seek out alternatives, to calculate consequences, to resolve uncertainties, and thereby ...to find ways of action that are sufficient unto the day, that satisfy.” ‘Rational decision making in business organizations’, Nobel Memorial Lecture, 8th December, 1978

¹³² Emiliós Avgouleas, ‘Reforming investor protection regulation: the impact of cognitive biases’ in Michael Faure and Frank Stephen, (eds), *Essays in the law and economics of regulation in honour of Anthony Ogus*, (Intersentia, The Hague, 2008), 143-166, 146

¹³³ Supra, note 130, (Sunstein), 1174

¹³⁴ Joshua Wright, ‘Behavioral law and economics, paternalism, and consumer contracts: an empirical perspective’, (2007) 2 New York University Journal of Law & Liberty 476

¹³⁵ Chapt 3, n15, (‘Turner Review’), 35

Theorem”.¹³⁶ It implicitly views the lender as best placed not only to undertake the affordability and suitability assessments but also to shoulder any losses if the assessment turns out to have been wrong viewed with hindsight many years hence.¹³⁷ The key issue is whether the FCA’s approach may prove to be beyond the capabilities of mortgage lenders both in terms of the risk that they make the wrong judgments about consumer mortgage affordability and, consequently, that their balance sheets prove too weak to sustain the cost of remediation work and consumer compensation at some future date. This issue could develop in a number of ways including higher cost mortgages to reflect this increased risk, a reduction in the provision of mortgages except to high-net-worth customers, or a subsequent taxpayer funded bail-out of broken mortgage lenders. All of these potential outcomes may have serious socio-economic and political consequences, aspects of which are considered in the following sections.

4.9 Socio-economic issues with the current approach

4.9.1 Socio-economic issues

The new MMR regulations protect those refused a mortgage from getting into unaffordable debt but the new rules may also prevent those who could afford the loan from obtaining their own home. This may well be of concern since, in the UK there is a powerful aspiration for homeownership and this issue and its implications for regulatory policy are considered in later chapters. The effect of regulatory decisions can be very wide-ranging since they are likely to have political and socio-economic consequences.¹³⁸ In many instances the results may only emerge slowly over time while regulators receive little praise if a potential crisis is averted. There are also a number of other socio-economic issues to be resolved. These include the growing problem of “mortgage prisoners” considered in the next section.

¹³⁶ Ronald Coase, ‘The problem of social cost’, (1960) *The Journal of Law and Economics*, Vol. 3, 2. In essence the theory states that losses between various parties are best distributed between them based on economic efficiency rather basing them on concepts of “fairness” and tortious or contractual rights

¹³⁷ Robert Cooter and Thomas Ulan, *Law and economics*, (6th Edition, Pearson, London, 2012), 81-102. There is a view that government regulatory intervention to correct market imperfection aimed at increasing market efficiency often only focusses on the “active” participant which in turn may produce consequential market imperfections, Richard Posner, *Economic analysis of law*, (8th Edition, Aspen, Wolters Kluwer, New York City, 2010), 64

¹³⁸ Ellis Ferran and others, *The regulatory aftermath of the global financial crisis*, (Cambridge University Press, Cambridge, 2013), 199

4.9.2 “Mortgage prisoners” and other market rigidities

The FCA recognises that there will be many thousands of consumers who, under these new rules, will not be able to move home although they are able to continue to pay their existing monthly mortgage payments. There are some limited transitional provisions to assist these “mortgage prisoners”.¹³⁹ There are various estimates of how many may be trapped and unable to move but up to two million households has been quoted.¹⁴⁰ A more recent report by the Resolution Foundation, a think tank whose objective is to “improve the living conditions of low to middle-income families”, claims that its research has identified some 3.5 million borrowers who may not be able to move since they would not pass more stringent affordability assessments required by the MMR.¹⁴¹ The concern is that as interest rates rise these “prisoners” will not be able to service their existing debts and will not be able to move to refinance their debt. As mentioned, the FCA rules do allow lenders to waive the affordability tests, if the borrower is moving and is not borrowing more than their existing liability and there is no increase in their interest out-goings.¹⁴² However, it is unclear how effective these rules are in ameliorating this issue. Nevertheless, the consequence of these new rules may be to reduce the flexibility of the employment market since consumers may not be able to move to areas where work is available and it could also make parts of the housing market more rigid. This issue may become more of a problem when interest rates increase and affect borrowers who wish to move to smaller and cheaper properties to reduce their costs and to release equity in their existing home in order to repay some, or all, of the amount outstanding on their mortgage. Separately, as mentioned earlier, there is also an increased risk that the new rules will encourage deceptive behaviour. It is likely that some otherwise honest consumers and intermediaries will attempt to work around the new rules and that some lenders may tolerate these contrivances.

¹³⁹ FCA, MCOB 11.7.1

¹⁴⁰ Independent, ‘*How to avoid becoming a mortgage prisoner*’, (31st May 2014)

¹⁴¹ Resolution Foundation, ‘*One in 10 mortgagors at risk of being trapped in ‘unaffordable’ borrowing finds new study*’, Press release, 20th May 2014, (However, the report does acknowledge that some of these borrowers may be able to renegotiate new mortgage deals with their lenders)

¹⁴² FCA, MCOB 11.6.3

4.9.3 Access to mortgage lending

It is possible that UK mortgage regulations may start to restrict access to mortgages, especially after the first few heavy enforcement actions. Coupled with the high price of houses the average age of the first time home-buyer has risen to around 35 or 37 compared with 28 ten years ago.¹⁴³ The MMR now makes it difficult to lend where the term may extend past the individuals retirement date due to the need to evidence affordability. This indicates that home buying may be limited to those between their mid-30s and 50. High-net-worth individuals are largely exempt from these restrictions.

The significant issue at stake here is that while regulation may remedy one problem it invariably results in unintended consequences. There needs to be a balance struck between competing harms. Consequently, there is a need for regulations to be subject to continuous monitoring in order to assess the effects they are having, especially when operated in combination with other regulatory measures and as demographics, economic conditions and markets change.¹⁴⁴ The FCA is well aware of all these concerns and, as a result, has initiated a review of competition in the mortgage sector” including the difficulties of switching products and suppliers.¹⁴⁵

Regulation has an important role and the regulators need to bear in mind the socio-economic effect of their actions. Aspects of these issues are considered in chapter 8 based, in part, on my discussions with UK politicians and regulators.

¹⁴³ DailyTelegraph, ‘Average first-time buyer is now 35’, (11th September 2012). However, the government’s “Help to Buy” scheme may have reduced this figure for some borrowers (see Daily Telegraph, ‘Help-to-Buy 2 shaves six years off first-time buyer age of 37’, (5th February 2015)

¹⁴⁴ Many have analysed this problem, however, the classic statement of the issue can be found in Friedrich Hayek’s, *New Studies in Philosophy, Politics, Economics and the History of Ideas*, (published 1967, Routledge, Oxford, 1978), 80, “Man does not so much choose between alternative actions according to their known consequences as prefer those the consequences of which are predictable over those the consequences of which are unknown.” Other examples include Donald Langevoort, ‘The human nature of corporate boards: law, norms, and the unintended consequences of independence and accountability’, (2000) 89 Georgetown Law Journal, 797, 818, which considers the effect of increased regulation on the composition and actions of corporate boards and the so called “Peltzman effect” where the danger of road accidents for pedestrians increased as vehicle drivers felt safer with the introduction of compulsory seat-belt wearing regulations, Sam Peltzman, ‘The effects of automobile safety regulation’, (1975), Journal of Political Economy Vol. 83, No. 4, 677-726

¹⁴⁵ FCA, ‘Call for Inputs on competition in the mortgage sector’, (October 2015)

4.9.4 Market effects

The new UK mortgage rules have substantially increased the barriers to entry for new lenders, not least by introducing capital requirements for non-deposit takers for the first time. This may be seen as part of a deliberate strategy to control lending since much of the property boom before 2007/8 was generated by a substantial influx of non-deposit taker lenders.¹⁴⁶ Finally, in this area mortgage regulation does not happen in a vacuum. The government is keen, for political, economic and social reasons, for mortgage lending to increase in order to reinvigorate the housing market and has employed a number of initiatives such as “New-build” and “Help to buy”. While regulators need to be cognizant of government policy they clearly have their own objectives which, for the most part, push in the opposite direction and restrict mortgage lending. The messages can be confusing. For example, FSA/FCA cost-benefit analysis of the proposed UK regulations estimated that only some 11% of good quality new mortgages would be prevented even in a booming market by the application of the new regulations.¹⁴⁷ The introduction of the MMR rules in April has coincided with a 5.5% fall in mortgage approvals compared with the same period in 2013 and a 17% fall compared with January 2014.¹⁴⁸ The Bank of England speculated that this may be due to the introduction of the new regulations.¹⁴⁹ The reductions are substantially higher than those predicted by the FSA.¹⁵⁰ However, it is too early to say what the underlying changes are and what the political, economic and social effects may be.¹⁵¹

4.10 Relying on conduct of business regulation

Finally, there is a significant question over how successful mortgage conduct of business rules have been and will be in the future. A FSA 2007 thematic review of the post-2004

¹⁴⁶ Supra, note 1, (‘Discussion paper, Mortgage Market Review’, 2009), 11. In the US context see Purnanandam, Amiyatosh, ‘Originate-to-distribute model and the subprime mortgage crisis’, (2010) University of Michigan

¹⁴⁷ Supra, note 74, (CP 11/31), 12

¹⁴⁸ Bank of England, Monetary Policy Committee Minutes 4th and 5th June 2014, 4 and 5

¹⁴⁹ Ibid, 4 and 5

¹⁵⁰ Supra, note 74, (CP 11/31, A3:1)

¹⁵¹ Daily Telegraph, ‘Mortgage approvals fall amid tough new tests for borrowers’, (2nd June 2014)

regulations, as mentioned above, disclosed significant regulatory failings by lenders and intermediaries.¹⁵² The FCA has started to review the operations of the MMR regime but it is too early to say how effective it has been. In the short period since the new MMR rules came into effect in April 2014 the FCA undertook 134 “mystery shops” across both lender and intermediaries and 40 customer interviews and six customer focus groups. The results were published in July 2015.¹⁵³ 59% of mystery shops resulted in suitable mortgage recommendations; in 3% (four cases) the advice was demonstrably unsuitable and in 38% the FCA was unable to determine whether the advice was suitable since the firm had failed to obtain sufficient information.¹⁵⁴

Based on the experience of investment business advice there is little reason to believe that these figures will improve significantly as time passes. However, it is possible to assert that some conduct of business mortgage regulation, no matter how flawed is better than none. Nevertheless, it is also difficult to establish the counter-factual of what would have happened if the 2004 MCOB rules had not been in place in the lead up to the financial crisis. However, it is possible to look at the effectiveness of the parallel investment business regulations, which have been in place largely unchanged from 1986 until the introduction of Retail Distribution Review (RDR) in 2013. This has been the subject of considerable regulatory enforcement action over the decades. Even as recently as 2011 there were five major FCA enforcement actions relating to the mis-selling of such products.¹⁵⁵ The effect of RDR is still to be determined but anecdotal indications are that the banning of commission payments combined with the higher cost of training investment advisers has led to the reduction of advisers operating in the “mass-market.”¹⁵⁶ It may be that investment business mis-selling has finally been cured by in effect closing, or significantly reducing, the market. After some thirty years, investment business may once again be the privilege of those in society who were wont to rely on the trusted family

¹⁵² Supra, note 58, (‘Mortgage effectiveness review: stage 2 report’, March 2008)

¹⁵³ Supra, note 35, (‘Embedding the MMR’, July 2015)

¹⁵⁴ Supra, note 35, page 3

¹⁵⁵ Combined Insurance Company of America (£2.8m), HSBC (£10.5m), Coutts (£6.3m), Credit Suisse (£5.9), and Norwich and Peterborough Building Society (£1.4m), FSA, ‘Fines Table’, (2011)

¹⁵⁶ Supra, note 145, (‘Call for input’), 6, “Currently not all consumers may be able to find the form of advice that they want... at a price they are prepared to pay ... There are a number of reasons why advice gaps may exist. There are barriers to people seeking advice; including, but not limited to, the cost of taking advice, lack of trust and lack of knowledge. There are also barriers to firms providing advice; including ... regulatory costs, ongoing liability for sub-standard advice and potential lack of clarity about regulatory expectations”

stockbroker. The mortgage market is still some distance away from this but its parallel, albeit lagging, regulation does not suggest that compliance with the conduct of business regulations will be any better.

4.11 Conduct of business regulation may not be effective

While it is too early to express a view on the revised mortgage conduct of business regulation, as mentioned earlier, the history of investment business conduct of business regulation has been one of failure. The history of conduct of business regulation is scattered with the debris of widespread product mis-selling activities. These included mis-selling personal pension and pension transfers in the early 1990s, mortgage endowments from the late 1980s to the end of the 1990s, split capital trusts in the 1990s and earlier 2000s, structured capital at risk products (scarps) in the early 2000s, payment protection insurance (PPI) in the mid-2000s, credit card protection, interest rate swaps in the mid-2000s and “packaged” bank accounts in the late 2000s. It is worth noting that banks in the UK fell outside the main application of the conduct of business regime until the introduction of statutory regulation in this area with the Financial Services and Markets Act 2000. Moreover, these examples, exclude problems with individual institutions which often transgressed.

There are a variety of reasons for all these failures over the couple of decades regulation in this area has been in place. They include incompetence at all levels, a failure by senior management to understand key elements of the business, mis-aligned targets and incentives, very poor culture and ethics and self-delusion as to what was in the interest of customers, carrying on traditional unethical practices without any self-reflection on whether they were right (eg “industrial business” savings schemes) and so on. In many cases the failures were due to boards setting or maintaining inappropriate business models often copying the behaviour of competitors in order, for example, to gain, or maintain, market share.

Some companies thought that they could distance themselves from misconduct by operating through “appointed representatives” (APs) who were not employees but this also failed since the actions of the APs were simply thought to be those of the regulated firm.

The regulators tried many initiatives to improve matters over the years and the scale and level of the fines increased with no discernible effect. For example, in 2003/4 the FSA launched its “treating customers fairly” initiative in an attempt to improve conduct of business in regulated firms.¹⁵⁷ However, the mis-selling scandals continued as before with PPI looking like it will cost the financial services industry around £30 bn in compensation. The introduction of the senior management and certified persons regime is the most recent approach. Additionally, the FCA’s Retail Distribution Review (RDR) has reduced the risk of investment business mis-selling by effectively reducing investment product selling by raising the cost of training and employing staff as financial advisers and prohibited the payment of commission.

A major premise of this thesis is that mortgage conduct of business regulation can substantially strengthen macroprudential policy. However, if this is to be effective there needs to be a better approach and this is considered in the next section.

4.12 A smarter approach to affordability assessment

The current system for assessing mortgage affordability is based on the original methods for preparing personal financial investment advice for a client. As mentioned, it is laborious and time consuming and prone to abuse. Income information is collected, normally, now by an intermediary and verified against some form of third-party documentation. However, expenditure figures are largely dependent on what a customer discloses in order to provide an estimate of “surplus” income available to service and repay the mortgage. Much of the affordability assessment process is automated and at least one major lender outsources this work to an IT service provider. Some lenders use either their own data or those provided by credit scoring agencies to carry out reasonableness assessment on the income and expenditure figures.¹⁵⁸ It is necessary, at all times, to maintain rigorous records for each decision in order to pass regulatory inspections and, possibly, to defend the lender against future customer litigation and complaints.

¹⁵⁷ FSA, ‘Treating customers fairly – towards fair outcomes for consumers’, (July 2006)

¹⁵⁸ For example, Experian’s web-site, ‘Assess the affordability of each customer’, (accessed 15th June 2017)

However, with the rapid development of financial technology (“fin-tech”) it should be possible for both intermediaries and lenders to use data access provided by the customer under, for example, the Payments Services Directive II. This could be used to assess mortgage affordability more accurately and with greater confidence and without the need for extensive customer interviews.¹⁵⁹ This may require the regulator to take the initiative since lenders are apparently too fearful to move in this direction themselves without regulatory approval due to the cost and potential regulatory risk.¹⁶⁰

4.13 A more targeted approach

The FSA/FCA’s approach to the MMR has been to ensure consumer protection with a form of “anticipatory” regulation. However, it is unlikely to suppress demand and it is likely that market pressures and the demand for credit to finance home purchases will put pressures elsewhere in the system. Moreover, regulation needs to be integrated into wider policymaking. At the heart of the problem is the failure in the UK to build sufficient housing to meet anything approaching the level of demand. The issue of housing supply is central to financial regulation in this area and is considered in chapter 8. In addition, there are possible lessons from the US and the next chapter looks at developing the US concept of the “qualified mortgage” and other options such as the “unitised mortgage” where the home is bought in incremental steps without the need to take on excessive debt at the outset.¹⁶¹

4.14 Conclusion

In the UK for the last ten or more years, the financial position of mortgagees has been relatively benign. Interest rates have been very low, in most areas house prices have risen and employment levels, even during the financial crisis have remained strong.¹⁶² However, under different economic conditions, for example, closer to those experienced in the early 1990s, the effects on borrowers and hence the economy, as a whole, could be very

¹⁵⁹ Directive 2015/2366 dated 25th November 2015 on payment services in the internal market

¹⁶⁰ FCA’s web-site, ‘Financial Conduct Authority provides update on regulatory sandbox’, (accessed 15th June 2017)

¹⁶¹ Chapt 3, n22, (House of debt), 218

¹⁶² Interest rate, employment levels and house prices

severe. Mortgage conduct of business regulation has an important role to play in ensuring the provision of meaningful information to prospective borrowers and in ensuring that marketing is fair, clear and not misleading. In addition, conduct of business regulation can help mould the approach taken by both lenders and intermediaries towards protecting consumers (eg the setting of targets and incentives, product design etc). Central to the regulations introduced in 2014 the affordability test seeks to protect consumers from over-borrowing. It adopts a paternalistic point of view aimed at protecting consumers from themselves.

This may have a number of possible effects. For example, as evidenced by the FCA's thematic review in 2015, as an unfulfilled demand for mortgages builds up the result may be that many consumers in their desperation to achieve a home of their own may be driven to fabricate or conceal information to be able to demonstrate that they can afford the loan they seek.¹⁶³

Second, mortgage conduct of business regulations have socio-economic implications. For example, homeownership and the aspiration of homeownership has a spiritual attraction. It provides an element of social stability with the homeowner having a financial stake in the well-being of the country and can embed them in the community. It has helped engender a willingness to save for the future if only to ensure that the outstanding mortgage is finally paid-off and many see the home as a method of saving for retirement. Much of this can be summarised in the phrase that the home forms both the major portion of a households "store of wealth" and a repository of hope for the future. The possession of the home may help ensure a good school and future career for the children; it may help provide for a comfortable retirement and may assist the next generation forming their own household and buying their own home in years to come. It demonstrates a firm belief in the future and a level of continuity and prosperity. The mortgage conduct of business regulations do not seek to address these concerns. The UK's FCA has consumer protection as one of its statutory objectives but this is not balanced by any need to consider the long-term socio-economic implications of its actions. The latter has a strong political dimension but ministers and the departments of state have tended to regard UK financial services regulation as a technical matter best left to the experts within the FCA. This demonstrates

¹⁶³ Supra, note 35, (FCA Thematic review, 2015). For example, Evening Standard, '*Trapped in a mortgage cage*', (13th October 2015), reports a survey by uSwitch that a quarter of of young female borrowers "lied about plans to start a family" for fear of having their application rejected

a failure to grasp the strategic issues binding regulation with socio-economic policy. More work is needed to see how consumer protection in the mortgage market, in the face of potentially very powerful market forces, can best operate taking account of socio-economic concerns.

Third, UK regulators have failed to consider the full implications of the new regulations. The all-encompassing rules will be breached at some point. Due to the sums involved mortgage remediation costs could potentially run into the tens of billions of pounds.¹⁶⁴ This could destroy the capital of lenders, forcing them into regulatory resolution with the possibility of taxpayer support.

Finally, it should be possible to redirect and target conduct of business mortgage regulation so that it better protects consumers but at the same time works with the grain of the socio-economic housing policy. This could include better targeted regulation since the assessment of mortgage affordability should lend itself to financial technology developments. The regulator could also look at US policy and the “qualified mortgage” concept considered in the next chapter. This should be an area for regulatory leadership. However, this aspect has not been prioritised.

¹⁶⁴ In 2015 household total debt in the UK (of which 80% related to mortgage borrowing was 139% of disposable income. This compares with equivalent figures in Spain of 120% and 115% in the US, Bank of England, ‘UK Housing Market Report’, (2015). The total value of all UK mortgages outstanding at the end of December 2015 was £1,282 Bn, (Bank of England and FCA Mortgage Lenders and Administrators Statistics for Q3 2015)

CHAPTER 5

Lessons from US mortgage conduct of business regulatory policy

"Thanks to the consumer agency's [Consumer Financial Protection Bureau (CFPB)] new rules, families will be safer...our whole economy will be safer...and the rules will reshape the mortgage market for the better. They will give people a better chance to buy homes and a better chance to keep those homes...These rules will help markets work better, and they will reduce the risk that the economy will crash again."¹

"The legislation that Rep. Ratcliffe and I are introducing today gives Congress the opportunity to free consumers and small businesses from the CFPB's regulatory blockades and financial activism, which stunt economic growth."²

5.1 Introduction

The UK is the main focus of this thesis. However, parts of the US also experienced a housing price boom fuelled by mortgage credit in the period leading up to the recent financial crisis. Nevertheless, in the course of my interviews of senior staff in a range of organisations I found that they tended to be somewhat isolationist in the perspectives. It is important to note the substantial differences between the housing and mortgage markets in the US and UK. However, there may well be lessons which each can learn from the other. This is the subject of this chapter and chapter 7.

Chapter 2 on macroprudential regulation considered the wide range of reasons given for the 2007/8 financial crisis. This chapter focuses on the interaction between mortgage lender, intermediaries and their customers and Federal legislation and regulations used to protect borrowers both before and after the crisis. Attributing causation is difficult. Some consider that the US Federal government's intervention in the housing market was a substantial reason for the financial crisis and this issue is considered in more detail in

¹ Elizabeth Warren, US Senator for Massachusetts web-site, 'Sen. Warren praises new CFPB mortgage rules that make families, economy safer', (7th January 2014), (accessed 16th June 2017)

² Ted Cruz, US Senator for Texas web-site, 'Sen. Cruz, Rep. Ratcliffe introduce legislation to abolish the CFPB', (14th February 2017), (accessed 16th June 2017)

chapter 7. It is unlikely that there was a single cause and it is more likely that there were a range of factors at work. The problems were compounded by poor financial supervision at all levels. This includes the unexplored aspects of the organisational structural and cultural reasons for the crisis. These issues apply to both the regulated businesses and the regulators. They can be grouped into four broad but over-lapping areas: the desire of individuals and organisational departments to self-restrict their areas of responsibility to those aspects with which they feel comfortable and resourced to address; a short organisational “attention span” due to changes in personnel, re-assessed priorities, new initiatives etc; a reluctance to use all the powers and regulatory “tools” available and, often coupled with the latter, a “Hamlet-like” level of indecision and a hope that the problem will resolve itself.³

Nevertheless, at the heart of the crisis was the supply of credit which drove-up property prices and these increased values, in turn, provided more security for more lending.⁴ Coupled with this is the view is that inadequate underwriting by lenders together with “predatory lending” - where borrowers were enticed into taking out loans beyond their ability to repay - were fundamental to the creation of the housing credit crisis.⁵ There was also a significant element of speculative property buying in a number of key “housing bubble” States.⁶ Shiller, echoing Minsky and Kindleberger considers that these types of bubbles are brought about by psychological factors driven by “herd” investing and leverage.⁷ It is these aspects which are central to this chapter with a focus on the

³ These factors will continue to exist, to a greater or lesser extent, no matter what systems of regulation and supervision operate. Aspects of these issues have been considered looking at organisation structure and management systems and compliance (eg Malloy, ‘Regulation, compliance and the firm’), chapt 2 n17, 451, (where the individual in the organisation can avoid making a decision to act by “redefining the situation so as to ensure that the norm is not activated, a cognitive process known as defensive denial”)

⁴ Atif Mian and Amir Sufi, ‘The consequences of mortgage credit expansion: evidence from the U.S. mortgage default crisis’, (November 2009) Quarterly Journal of Economics, 122(4):1449-1496

⁵ Chapt 2 n26, Khandani, ‘Systemic risk and the refinancing ratchet effect’. See also Andrey Pavlov and Susan Wachter, ‘The inevitability of marketwide underpricing of mortgage default risk’, (Winter 2006), Real Estate Economics, Vol. 34, Issue 4, 479-496, 494-495

⁶ Andrew Haughwout, Donhoon Lee, Joseph Tracy and Wilbert van der Klaauw, ‘Real estate investors, the leverage cycle and the housing market crisis’, (September 2011) Federal Reserve Bank of New York Staff Report No. 514, 1 and 40

⁷ Chapt 3 n22, (Shiller, *Irrational exuberance*), 149 - 153 and chapt 2 n58, Kindleberger explains and applies the Hyman Minsky’s “model” in ‘Manias, panics and crashes’, 15-20. See also chapt 2 n51, Minsky, ‘The financial instability hypothesis’, 4-6 and Karl Case and Robert Shiller, ‘Is there a bubble in the housing market?’, (2003) Cowles Foundation for Research in Economics, Yale University, Foundation Paper No. 1089

regulation of the interaction between borrowers, lenders and intermediaries as the development of mortgage conduct of business regulation in the US seeks to balance protecting consumers from over-borrowing while maintaining access to the aspiration of homeownership.

As a consequence of the financial crisis and the need to reform the conduct of financial service providers towards consumers, the Dodd-Frank Act established the new Consumer Financial Protection Bureau (CFPB).⁸ This marked a significant change in US Federal regulation.⁹ Previously, how lenders and intermediaries conduct their business with borrowers was largely a matter for individual States. There were Federal requirements governing the disclosure of information to borrowers but it was not clear which Federal agency supervised this aspect of regulation. This all changed when the CFPB started work. The role of the CFPB is considered further in this chapter.

In particular there are five key themes to this chapter. First, it is necessary to understand the political and socio-economic context and the importance of homeownership as part of the “American Dream” and the bi-partisan political support this concept enjoyed. This theme is central to understanding the US approach to consumer mortgage protection where, as mentioned, the government has intervened to continue to provide access to credit to finance home loans and also set up the CFPB, as a powerful regulator, to protect borrowers. As mentioned in chapter 4, the UK shares aspects of this belief in the importance of homeownership. The cultural, political and socio-economic elements influencing popular aspirations towards owning a place of ones’ own and how this is financed have a strong influence on both the regulatory approach and government policy. These aspects are considered in chapter 7 on the role of the US Federal government and possible lessons from government interaction in the housing and mortgage markets and their regulation.

Second, in the US the quality of mortgage lending in the period leading up to the start of the financial crisis was uneven. This has implications for regulatory policy. Consequently,

⁸ The Act’s full title is: “Dodd-Frank Wall Street Reform and Consumer Protection Act” (124 STAT. 1376 Public Law 111–203—July 21, 2010, H.R. 4173)

⁹ Timothy Geithner, *Stress test*, (Random House Business Books, New York, 2014), 427. The former US Treasury Secretary describes the establishment of the CFPB as “the most important new US regulatory body since the Environmental Protection Agency ...[covering] debt collectors, pay-day lenders, credit reporting firms, mortgage originators, student loan servicers and other operators who used to evade scrutiny”

this chapter seeks to identify and consider what the problems areas were. This includes understanding who the problematic borrowers were and, specifically which mortgage products caused the most damage and the role of the intermediaries who often promoted these types of loans. This chapter then examines the regulatory changes both in terms of structure and content and how these changes have been implemented. This form of analysis will help determine whether the current solutions will work and what other steps can be taken.

Third, as a centralised Federal organisation the CFPB is too remote from the day-to-day operations of the mortgage market in such a large and diverse nation. It needs to persuade individual States to act, to set best practice and to monitor and report on what is happening and to act as a conduit to share both best practice and information on what is happening locally. It will also give individual States opportunities to experiment to find what works best and to avoid some attempt at operating a centralised “command and control” system.

Fourth, this chapter questions the extent to which reliance can be placed on providing customers with extensive disclosure material. Finally, this chapter considers the ‘Qualified Mortgage’ as a regulatory concept and whether it may be beneficial to adopt it in the UK.

5.2 The context: borrowers, lenders and products sold

It is important to consider what types of borrowers existed in the lead up to the housing boom in the late 1990s and early in the 2000s and their interaction with the lenders. This analysis will assist in determining whether the conduct of business actions taken after the crisis are likely to be effective. US homeownership rates were around 44% in 1935 (the end of the Great Depression).¹⁰ They then rose steadily until reaching a plateau in 1970 at 64% before sharply rising again from 1997 to 69% just before the financial crisis.¹¹ The increase in homeownership was largest among “Hispanic, Black and Asian groups (16-17%) compared with an 8.6% increase for non-Hispanic Whites.”¹² The stock of

¹⁰ Carlos Garriga, William T. Gavin, and Don Schlagenhauf, ‘Recent trends in homeownership’, (September/October 2006) Federal Reserve Bank of St. Louis Review, 88(5), 397-411, 398

¹¹ Ibid, 398

¹² Ibid, 400

mortgages “lent by US banks to US households went from 15% of GDP in the 1970s to 96% in the 2000s. In the 1970s, one in ten Dollars lent out by US banks was towards a mortgage; but in the 2000s, this was one in three.”¹³

Problems became evident in 2006. In 2005 only just over 1% of mortgages were classified as in default within their first two years of inception. This figure doubled in the period 2006-2008.¹⁴ For sub-prime loans the default figures increased from 10% in 2006 to 40% in 2010.¹⁵ The Triennial Survey of Consumer Finances found homeownership “rose from 63.9% in 1992 to 69% in 2004 and the share of households with a mortgage rose from 38.4% to 45%”.¹⁶ In 1998 almost 100% of mortgages were written as 30 year fixed rate loans.¹⁷ This percentage had fallen to 35% by 2004 and did not rise much above 40% by 2007.¹⁸ By the end of 2009 40% of the subprime adjustable rate mortgages (ARM) policies were seriously delinquent.¹⁹ This percentage rose to 53% for ARMs sold between 2005 and 2007 compared with 48% for fixed rate mortgages sold during the same period.²⁰ The delinquency rate for prime ARMs rose from “0.6% in 2005 to 18% by the end of 2009.”²¹ ARMs “by the end of 2007 represent 22% of outstanding mortgages but 62% of...foreclosures.”²² By “mid-June 2010 4.6% (about 2.2m properties) were in foreclosure and another 4.8% (about 2.3m) were 90 days past due.”²³ Further, is evidence that the

¹³ Dirk Bezemer, ‘Schumpeter might be right again: the functional differentiation of credit’, (November 2014), *Journal of Evolutionary Economics*, Vol. 24, Issue 5, 935-950

¹⁴ CFPB, 12 CFR Parts 1024 and 1026, RIN 3170-AA19, 12-13

¹⁵ Ibid, 13, There are a variety of definition of “sub-prime” all of which attempt to capture the increased riskiness of the borrower. The measures include credit scores, high LTV and high interest rate loans, see Oren Bar-Gill, ‘The law, economics and psychology of sub-prime mortgage contracts’, (2009) 94 *Cornell Law Review* 1073-1151, 1087-1088

¹⁶ Daniel Bergstresser and John Beshears, ‘Who selected adjustable-rate mortgages? Evidence from the 1989-2007 Surveys of Consumer Finances’, (2010), Harvard Business School, Working Paper 10 083, 2

¹⁷ Rajdeep Sengupta, ‘Alt-A: the forgotten segment of the mortgage market’, (January/February 2010) *Federal Reserve Bank of St. Louis Review*, 92(1), 55-71, 58

¹⁸ Ibid, Table 1, 58

¹⁹ The issue of adjustable rate mortgages is considered in more detail later in this chapter.

²⁰, Chapt 2, n18, (Bubb and Krishnamurthy, ‘Regulating against bubbles’), 1606

²¹ Supra note 17, (Sengupta) Table 1, 58

²² Supra, note 16, (Bergstresser and Beshears), 6

²³ John Campbell and others, ‘Consumer finance policy: Implementing two-tier mortgage regulation’, (December 2010), Russell Sage Foundation, 1

increase in problem mortgages was skewed towards those with "cognitive limitations" and that "poor numerical ability correlates with missed payments and defaults."²⁴

This data paints a picture of a rapid rise in homeownership starting in the late 1990s and accelerating in the final years leading up to the collapse in 2006/7. This rise was largest in the first time buyer, minority and single parent demographic groups.

It is worth noting that ARMs are not inherently problematic. They are a standard type of mortgage sold in the UK, Australia, Canada etc.²⁵ The issue appears to be that ARMs were sold with low initial premium periods, which low-income borrowers were able to afford with a significant increase in the monthly repayment some years later. The position is further clouded by the development of the "Alternative-A" ("Alt-A") mortgage market. Traditionally those whose credit was impaired due to, for example, past unpaid debts borrowed in the sub-prime mortgage market. Alt-A mortgage products were normally used by those with good credit scores who were unwilling or unable to provide supporting documentation for their income declaration as part of the mortgage underwriting process. These individuals were normally self-employed and were often paid periodically in cash. Between 2001 and 2003 subprime mortgage origination grew by 95%.²⁶ The "comparable growth rates between 2003 and 2006 for the subprime and Alt-A segments were 94% and 340%, respectively."²⁷ Both sub-prime and Alt-A mortgages experienced very high default rates usually within the first twenty-four months after origination with significantly worse outcomes for those written after 2003.²⁸ Nevertheless, significant losses still came from the traditional fixed rate market.²⁹

²⁴ Supra note 16, (Bergstresser and Beshears), quoting research by Gerardi, Goette and Meier in 2009 on New England subprime mortgages, 5-6 (Kristopher Gerardi, Lorenz Goette, and Stephan Meier, 'Financial literacy and subprime mortgage delinquency: evidence from a survey matched to administrative data', (2010) Federal Reserve Bank of Atlanta, Working Paper 2010-10)

²⁵ Emanuel Moench, James Vickery, and Diego Aragon, 'Why is the market share of adjustable-rate mortgages so low?', (2010), *Current Issues in Economics and Finance*, Vol. 16, No. 8

²⁶ Supra, note 17, (Sengupta), 56

²⁷ Supra, note 17, (Sengupta), 56

²⁸ Supra note 17, (Sengupta), 65

²⁹ Michael Lea and Anthony Sanders, 'Government policy and the fixed-rate mortgage', (2011), *Annual Review of Financial Economics*, 3, 223–234, 230, "The 30-year fixed-rate mortgage remains the fool's gold standard for mortgages throughout the United States, offering superior stability for some homeowners and potential catastrophe for U.S. and global financial systems"

It is clear that the quality of lender underwriting declined in the early 2000s and more sharply after 2003 in all sectors. However, prospective borrowers' initial contacts were with intermediaries and not the lenders and many of the issues relate to this interaction.³⁰ By 2005 some 60% of sub-prime loans were originated by mortgage brokers.³¹ Mortgage brokers have been described as being the "engines of the sub-prime market."³² They were remunerated by lenders and were regulated, if at all, at the State level. For example, New Century Financial Corporation (New Century) had "more than 7,100 employees and 222 sales offices nationwide, and was one of the largest subprime mortgage originators in the United States".³³ "In 1996, the company originated over \$350 million in loans. In 1997, New Century went public and was listed on NASDAQ. In 2001, the company's subprime loan origination volume exceeded \$6 billion. Volume continued to grow rapidly, and volume increased tenfold to over \$60 billion in 2006."³⁴ In April 2007 the company filed for Chapter 11 protection. Between 1997 and 2005 some 30-40% of all its loan applications were made with no documents to support the mortgage applicants' income declaration (with a figure of 42% in 2004: the high point of this practice).³⁵ For example, of the loans originated by New Century in 2005, 7% were in default within 15 months.³⁶ It is difficult to

³⁰ It is also worth noting that many of the mortgage "originators" were both mortgage brokers and lenders and often had parent companies that held mortgage securitisations. These groups in effect were "eating their own cooking", (Bubb and Krishnamurthy), chapt 2, n18. For example, the largest mortgage originators besides New Century were Ameriquest (a savings and loan association) part owned from 1999 by Washington Mutual and closed in 2007, First Franklin bought by Merrill Lynch in December 2006 and wound-down in 2008; WMC bought by GE Money in 2004 and closed in 2007; Fremont Investment and Loans (a savings and loan association) closed when its parent company filed for bankruptcy in 2008; BNC bought by Lehman Brothers in 2003 and closed in 2007; Countrywide Financial which demerged its savings and loan operation: IndyMac Bank in 1997, was sold in 2008 to Bank of America; Aegis owned by Cerebus Capital, a private equity firm filed for bankruptcy in 2007, and Option One, owned by H&R Block, a tax planning business, closed in 2009. In addition a number of major banks had their own mortgage originators trading under their parents' names, for example, HSBC (formerly HFC), CitiMortgages, Wells Fargo and GMAC Residential Funding. All these businesses were either closed or filed for bankruptcy between 2007 and 2009, (Bubb and Krishnamurthy), and The Centre For Public Integrity website, <http://www.publicintegrity.org> (accessed 24th February 2017)

³¹ Mortgage brokers accounted for 59.3% of subprime originations in 2005. 'Brokers flex their muscle in 2005, powering record subprime year, inside B&C lending', (March 2006) reported in Ellen Schloemer and others, 'Losing ground: foreclosures in the subprime market and their cost to homeowners', (December 2006), Center for Responsible Lending

³² Mark Fox and David Lane, 'Lessons from the US subprime mortgage crisis', (2008) Journal of International Banking Law and Regulation, 449

³³ Antje Berndt, Burton Hollifield and Patrik Sandas, 'The role of mortgage brokers in the subprime crisis', (2009), NBER Working Paper 16175, 5

³⁴ Ibid, 6

³⁵ Ibid, 33

³⁶ Ibid, 39

be precise about who was most at fault in writing such poor quality business. There was a congruence of interests: many borrowers, who would not normally have been able to do so, were able to buy and keep their homes, others were able to borrow against the equity in their properties to fund other expenses or to speculate in the housing market, brokers were remunerated by lenders dependent on the volume and profitability of the mortgages they originated and lenders used cheap funds to produce high returns.

The role of mortgage brokers has largely been overlooked. It is clear that brokers are “salesmen”.³⁷ Many of the problems could have been prevented if adequate conduct of business regulations, backed by sound supervision, had been in place. This chapter will return to this aspect of the broad theme and how intermediaries should be regulated and supervised. After the crisis, as mentioned above, many borrowers, but not all, were evicted and the business of both lenders and brokers collapsed. The issues, as mentioned earlier, appear to have been exacerbated by property speculation and the picture is not complete until this aspect is also considered.

5.3 “Bubble states” and investor borrowers

The role of four US “housing bubble” states and the rise of house-buying investors appears to be a little explored aspect to the recent financial crisis. The data indicates that in four US states (Arizona, California, Florida and Nevada) house prices doubled between 2000 and 2006 with most of the increase dating from 2004 and that this was significantly higher than in the rest of the country.³⁸ Most of this activity in these housing markets was generated by housing investors owning two or more properties and that these individuals were major drivers of growth in non-prime securitised mortgages.³⁹ The patterns of trading indicate that these investors were a mixture of those interested in buy-to-let operations and those looking for a quick resale of the properties into a rapidly rising market.⁴⁰ Some 25% of the Alt-A market was used to finance these types of investments.⁴¹ The implications are that these borrowers would seek any finance they could and were largely impervious to

³⁷ Susan Woodward and Robert Hall, ‘Diagnosing consumer confusion and sub-optimal shopping effort: theory and mortgage-market evidence’, (December 2012) *The American Economic Review*, 4

³⁸ *Supra*, note 6, (Haughwout and others), 1 and 40

³⁹ *Supra*, note 6, (Haughwout and others), 25

⁴⁰ *Supra*, note 6, (Haughwout and others), 9-11

⁴¹ *Supra*, note 15, (Bar-Gill), 1112

interest rates and costs since they did not expect to hold the property for long. Again this aspect has implications for regulation and this area is considered in the next section.

5.4 The Legislative approach: overview

As mentioned earlier, at the heart of the crisis there was poor mortgage underwriting. The common confusion between mortgage underwriting and mortgage affordability is addressed in chapter 4. In the US these separate issues were conflated in two broad changes to consumer financial protection following the financial crisis. The first was to strengthen existing legislation and, the second, as mentioned earlier, was to adopt a new approach to consumer protection with the creation of the CFPB and the passage of the Wall Street Reform and Consumer Protection Act 2010 (“Dodd-Frank”).⁴² This Act also amended the Truth in Lending Act 1968 (TILA), covering disclosure of information on mortgage costs for customers and the Real Estate Procedure Settlement Act 1974 (REPSA) covered other aspects of disclosure and which prohibited undisclosed payments between intermediaries and lenders as well as misleading loan advertisements.⁴³

The CFPB is responsible for most rule-making in these areas of legislation. For example, loan applications made after 1st August 2015 are now subject to the “TILA-RESPA Integrated Disclosure Rule” or “TRID”.⁴⁴ The CFPB was also given the role of enforcing these pieces of legislation. How this has been implemented in the “Know before you owe” initiative is discussed in the next section. Of particular relevance is that Dodd-Frank now requires lenders to “make a reasonable and good faith determination, based on verified and documented information, that the consumer will have a reasonable ability to repay the loan.”⁴⁵ There are also new requirements regarding the provision of information to

⁴²Title X. The CFPB was set up under the Consumer Financial Protection Act (CFPA) passed under the Dodd-Frank “umbrella” legislation

⁴³ Truth in Lending Act 1968 (TILA), 82 STAT. 146, Public Law 90-32. The regulations implementing the statute, which are known as “Regulation Z”, are codified at 12 Code of Federal Regulations 226. Real Estate Procedure Settlement Act 1974 (REPSA) is codified 12 U.S.C. §§ 2601-2617

⁴⁴ TILA-RESPA Integrated Disclosure Rule: Guide to the Loan Estimate and Closing Disclosure forms (January 2015). As the name implies these rules combine the disclosure requirements set out in a number of earlier consumer protection regulations

⁴⁵ s1411 Dodd-Frank, codified as 15 U.S.C. 1639c

consumers to improve their understanding of mortgage transactions and this aspect will be considered later in this chapter.⁴⁶

5.4.1 Summary of the revised regulations

Dodd-Frank makes the CFPB responsible for setting detailed rules and enforcing a range of legislation including TILA, RESPA, the Equal Credit Opportunity Act (ECOA) 1974 (banning lenders discrimination on grounds of race, gender etc), Home Mortgage Disclosure Act ("HMDA") 1975 (requiring lenders to provide information, which is made public, on its lending practices to the CFPB).⁴⁷ Previously it was unclear which Federal agencies had responsibilities for enforcing these pieces of legislation.⁴⁸ These are now all the responsibility of the CFPB.

The CFPB also has responsibility for the SAFE Mortgage Licensing Act.⁴⁹ The latter required the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve Board, the Federal Deposit Insurance Corporation, the former Office of Thrift Supervision, the National Credit Union Administration, and the Farm Credit Administration (collectively, the Agencies), to jointly develop and maintain a Federal registration system ("Federal Registry") for individual employees of Agency-regulated institutions who engage in the business of residential mortgage loan origination. Subsequently, the Federal Registry was established and has been operational since January 2011. Dodd-Frank Act transferred the authority to develop and maintain the Federal Registry from the Agencies to the CFPB. The SAFE Act statute requires individual mortgage loan originators employed by "Agency-regulated" institutions to be registered with the Nationwide Mortgage Licensing System and Registry (Federal Registry), a database established previously by the Conference of State Bank Supervisors (CSBS)

⁴⁶ CFPB, 'Final rule on simplified and improved mortgage disclosures', (November 2013) s1032f of Dodd-Frank codified as 12 USC 5532(f)

⁴⁷ Equal Credit Opportunity Act (ECOA) 1974, 15 U.S.C. § 1691 and Home Mortgage Disclosure Act ("HMDA") 1975, 89 STAT. 1124 Public Law 94-200

⁴⁸ Leonard Kennedy, Patricia McCoy and Ethan Bernstein, 'The Consumer Financial Protection Bureau: financial regulation for the twenty-first century', (2012) 97 Cornell Law Review, 1141

⁴⁹ The Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (122 Stat. 2810 Public Law 110-289), Federal Financial Institutions Examination Council Guidance website, <https://www.ffiec.gov/safeact.htm>, (accessed 28th June 2017)

and the American Association of Residential Mortgage Regulators to support the licensing of mortgage loan originators by the States.⁵⁰

The CFPB has based its consumer protection strategy on improving the disclosure of information to consumers prior to them taking out a new loan. The disclosure rules existed before the financial crisis. They were augmented by the Federal Reserve in 2008 and amended by the Dodd-Frank legislation.⁵¹ Previously there were two different disclosure documents required by two different pieces of legislation. As mentioned earlier, Dodd-Frank empowers the CFPB to combine these into a new document. As part of a “Know before you owe” initiative the CFPB consequently designed two new forms.⁵² The first of these: “the Loan Estimate”, provides information on the key features, costs, and risks of the mortgage. It must be provided to consumers within three business days after they submit a loan application. Second, “the Closing Disclosure” provides information on all the costs of the transaction. This document is five pages long combining two previous disclosure statements and came into effect from August 2015.⁵³ This latter document must be supplied at least three business days before the mortgage contract is completed. The CFPB has tested all these documents on nearly a thousand consumers to check that they are clear and understandable. However, this information is provided very late in the mortgage process. The effectiveness of information disclosure is considered later in this

⁵⁰ Bryce Gray, ‘The Secure and Fair Enforcement for Mortgage Licensing Act of 2008’, (2011) 31 Review of Banking and Financial Law, 51. The SAFE Act 2008 was enacted as part of the Housing and Economic Recovery Act 2008 “to set up a national licensing and registration system for individuals working as mortgage loan originators. Previously this was a matter for individual States. The aim of the legislation is to: facilitate responsible behavior in the subprime mortgage market place”. The responsibility for licensing is placed on each State. It exempts those employed by institutions supervised by a number of Federal bodies (eg Federal Reserve, FDIC etc). States had one year to pass their own legislation to implement the law. It specifies fingerprinting, examinations, training, background checks etc. There are similar requirements imposed on Federal agencies for those they supervise

⁵¹ Bureau of Consumer Financial Protection 12 CFR Part 1026 CFPB-2011-0008; CFPB-2012-0022] RIN 3170-AA17 Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z). Bureau of Consumer Financial Protection 12 CFR Parts 1024 and 1026 [Docket No. CFPB-2012-0028] RIN 3170-AA19

⁵² Supra, note 48, (Kennedy), 1161 and Michael Mierzewski and Jeremy Hochberg, ‘CFPB proposes new mortgage disclosure rules’, (2012) 129 Banking Law Journal, 809

⁵³ Mark Samra, ‘New regulation under the CFPB’, (2012) 31 Review of Banking and Financial Law, 545

thesis. The CFPB has also strengthened the mortgage affordability requirements and this aspect is considered next.⁵⁴

5.4.2 Ability to repay

In assessing a borrower's ability to repay the mortgage the CFPB expects the lender to consider a number of factors including current or reasonably expected income, employment status, currently and proposed debt obligations, other obligations such as "alimony, and child support, the monthly debt-to-income ratio or residual income," and the consumer's credit history. This information must be verified with "reasonable third party sources".⁵⁵ There are special calculations for variable-rate mortgages and "balloon and interest-only payments, or negative amortization."⁵⁶ The lenders' compliance with these regulations is now enforced by the CFPB.⁵⁷ This approach is not without controversy since there is a view that it may contravene the Fair Housing legislation since minorities seeking to become homeowners may have the most difficulty demonstrating their ability to repay.⁵⁸

There are two arms to the CFPB's enforcement role and a third relating to contract enforceability. These are not mutually exclusive. The CFPB can take action itself or it can rely on private litigation based on CFPB regulations. The new private right of action provides special damages for borrowers who find themselves with an unaffordable loan.⁵⁹ For a three-year period following closing, borrowers may bring an action alleging the lender failed to make a reasonable good-faith determination of their ability to repay the loan. Failure to properly assess affordability can also be raised as a defense to

⁵⁴ CFPB website, 'Summary of the ability to repay and qualified mortgage rule and the concurrent proposals', http://files.consumerfinance.gov/f/201301_cfpb_ability-to-repay-summary.pdf, (accessed 24th July 2017). See also Susan Block-Lieb and Edward Janger, 'Reforming the regulation of the market for home loans', (2011) Fordham Urban Law Journal, Fordham University School of Law and Brian Rogers, 'Mortgage origination standards', (2011) 31 Review of Banking and Financial Law, 92

⁵⁵ Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed Reg. 6408 (30th January 2013) (codified at 12 C.F.R. pt. 1026). See also: Michael Mierzewski and others, 'CFPB finalizes ability to repay and qualified mortgage rules', (2013) 130 Banking Law Journal, 611

⁵⁶ Ibid, (12 C.F.R.), 1026.43f

⁵⁷ Truth in Lending (Regulation Z) 15 U.S.C, 1639c; 12 C.F.R., 1026.43

⁵⁸ Nicolas Cassidy, 'The Fair Housing Act, disparate Impact and the ability-to-repay: a compliance dilemma for mortgage lenders', (2013) 32 Review of Banking and Financial Law, 431

⁵⁹ 15 U.S.C., 1639b(d) and more generally 15 U.S.C. 1640

foreclosure. There are limits set for calculating the damages.⁶⁰ The “mortgage originator” as well as the “creditor” can also be liable to pay these damages. The former includes individual loan officers and mortgage brokers, both individuals and businesses.⁶¹ Consequently, there are now three separate but related risks faced by firms and individuals: direct action by a Federal agency, the threat of private litigation and the possibility that the lender may be unable to enforce a foreclosure. However, in parallel, lenders and intermediaries are encouraged to provide less risky, standardised “qualified mortgages”. This important aspect is considered in the next section.

5.5 The “Qualified Mortgage”

Dodd-Frank has created a “safe harbor and rebuttable presumption” for residential mortgages that satisfy a number of criteria described below.⁶² These types of secured loan are termed “qualified mortgages” under the legislation.⁶³ If a mortgage satisfies the “qualified mortgage” requirements there is no need to carry out an ability to repay assessment. This element in the regulations is very different in concept to the approach taken in the UK. Dodd-Frank requires that a “qualified mortgage” meets certain requirements including no negative loan features (ie “negative amortization, interest-only payments, balloon payments, or terms exceeding thirty years”), no mortgages where fees paid by the consumer exceed three percent of the total loan amount and “no documentation” loans are excluded from being qualified mortgages.⁶⁴ Finally, “that monthly payments be calculated based on the highest payment that will apply in the first five years of the loan and that the consumer have a total debt-to-income ratio that is less than or equal to 43 percent.”⁶⁵

⁶⁰ Damages in these actions are limited to: “the greater of actual damages or an amount equal to three times the total amount of direct and indirect compensation or gain accruing to the mortgage originator in connection with the residential mortgage loan involved in the violation. (15 U.S.C., 1640(c). Action can also be brought by the State Attorney General, Germán Salazar, ‘Mortgage lending’, (2015) 51 March Arizona Attorney 18). Class action damages are available, as with other TILA actions, limited to the lesser of \$1 million or one percent of the creditor's net-worth. (15 U.S.C. 1640(a)(2)(B))

⁶¹ 15 U.S.C. 1639b(d)(1)

⁶² 15 U.S.C. 1412

⁶³ 15 U.S.C. 1412(b)(2)(A)

⁶⁴ Supra, note 55, 43 (e) (2)

⁶⁵ Supra, note 55, 43 (e) (2). See also David McDaniel and Robert Riley, ‘Federal Reserve Board proposes ability to repay rules for consumer mortgages’, (2011), 128 Banking Law Journal, 652

In conceptual terms the “qualified mortgage” exemption establishes a level of legislative and regulatory risk tolerance. For example, UK conduct of business regulations place sole responsibility for ensuring that a prospective customer can afford the mortgage fully on the lender and the UK regulations do not contemplate any level of error tolerance. Under the UK’s regulatory system a lender is exposed to regulatory and compensatory action if a mortgage has been deemed to have been mis-sold. There is no equivalent “safe harbour” or public interest defense or safeguard. In contrast, the US regime accepts, for public policy reasons linked to the benefits of homeownership mentioned earlier, that there are certain standard types of mortgage contract that do not warrant an “ability to pay” test. The regulators appear to have accepted that in due course some borrowers will not be able to service or repay these types of mortgage but that the public policy benefits of wider homeownership outweigh this risk. The evidence is that of the mortgages which were “qualifying mortgages” under TILA written in 2005-8, “23% were in default compared with 44% that did not meet the qualifying mortgage requirements”.⁶⁶ This properly leaves the issue of risk in the provision of housing finance and its relationship with consumer protection as a matter of public policy and not one solely determined by the regulator. This is important since if the issue is left to the regulator the latter, for understandable institutional and regulatory objective reasons, is likely to devise the most restrictive regulations. In practice there are many more public policy issues at stake and these need to be considered as well. These include matters of housing policy and socio-economic factors. Consumer protection is an important element in these deliberations and needs to be considered and balanced against other objectives. Besides address regulatory issues the US legislation also looks at the important private law implications of the regulations.

In private law terms the regulatory safe harbour for a “prime qualified mortgage” is almost invulnerable since the consumer will be deemed to satisfy the ability to repay test. For a “sub-prime qualified mortgages” there will be a rebuttable presumption that the consumer has met the ability to repay requirements. The CFPB have interpreted this to mean that consumers would need to rebut this presumption for a “qualified mortgage” by showing that “at the time the loan was originated, the consumer’s income and debt obligations left

⁶⁶ Daniel Chatlos, ‘Grabbing the bull by the horns: the future of mortgage lending and securitization in the aftermath of the financial crisis’, (2014), 25 University of Florida Journal of Law and Public Policy, 137-164, 148

insufficient residual income or assets to meet living expenses.”⁶⁷ Guidance accompanying the rule notes that “the longer the period of time that the consumer has demonstrated actual ability to repay the loan by making timely payments, without modification ... the less likely the consumer will be able to rebut the presumption based on insufficient residual income.”⁶⁸ However, the CFPB was concerned that the market for non-qualified mortgages might disappear, therefore it created a temporary rule permitting another category of qualified mortgages that do not need to meet all the qualified mortgage provisions and which will not require the ability to repay checks provided the various government agencies (eg U.S. Department of Housing and Urban Development, Department of Veterans Affairs) will purchase or insure these mortgages. The expectation is that these types of mortgages will be phased out within seven years, if not earlier.⁶⁹ It is important to note that the ability to repay assessment should not to be confused with a credit appraisal which is necessary for any lender and is required for prudential regulatory purposes. It is likely that lenders will in future concentrate on the provision of qualified mortgages as a means of defending themselves from future litigation.⁷⁰ It is also possible that the mortgage refinancing market may only accept “qualified mortgages” due to the risk of litigation and the difficulties in unwinding complex mortgage arrangements.⁷¹

In conclusion, the concept of the “qualified mortgage” is attractive in that it is “based on a vision of housing as a foundation for a stable life for homeowners and their families” and regulation consequently encourages lenders both to produce a simple, “vanilla” product and to avoid troublesome innovation.⁷² The view is developing that while innovation may produce good mortgage products it is generally a malign influence.⁷³ Consequently, Dodd-Frank encourages lenders, by reducing the regulatory requirements for suitability and affordability assessments, to provide the standardised “qualified mortgage”. This chimes in

⁶⁷ Supra, note 55, 43b,

⁶⁸ Supra, note 55, 43 (e) (I)

⁶⁹ Supra, note 54, CFPB summary 12 CFR

⁷⁰ Elizabeth McKeen and others, ‘Mortgage underwriting: the qualified mortgage and the ability to repay’, (2012) 129 Banking Law Journal, 829

⁷¹ Stephen Ornstein, and others, ‘CFPB ability to replay rule and qualified mortgage definition’, (2012) 66 Consumer Finance Law Quarterly Report, 424

⁷² Michael Barr and others, ‘Behaviorally informed financial services regulation’, (New American Foundation, October 2008)

⁷³ Neil Seitz and others, ‘Bank integrity: the case of subprime lending’, (2009) 30(9) Company Lawyer, 277

with the approach advocated by Barr and others mentioned earlier advocating a “standard mortgage product” which is “sticky”.⁷⁴ Use of such products will prevent sub-prime lending and the use of noxious contractual clauses and charging arrangements. Nevertheless, much will depend on the effectiveness of the CFPB and its initial operations are considered in the next section.

5.6 The CFPB in operation

Consumer financial protection existed before the CFPB regime but it was seen as severely “flawed with consumer protection as an “orphan” mission that had no regulatory “home” in any single agency and subordinated to regulatory concerns about [ensuring] bank profitability. [The regulators were seen as lacking] expertise in consumer financial issues” and with responsibility spread across many Federal and State agencies this “created regulatory arbitrage opportunities.”⁷⁵

The call for a “Consumer Product Safety Commission” pre-dates the financial crisis and is in part based on the work of Professor Elizabeth Warren.⁷⁶ The CFPB defines its two objectives as “helping consumer markets work” and “empowering consumers to take more control over their economic lives”.⁷⁷ It mainly satisfies these objectives by a combination of consumer education and information provision and ensuring that regulated firms provide standard and consistent information to consumers. It also makes regulations and carries out regulated firm assessments. Additionally, the CFPB’s also has enforcement powers but these are limited to banks with more than \$10 billion in net assets, or only just over a hundred institutions out of over 16,000 banks.⁷⁸ Many of the latter are authorised by the States and not by Federal regulators. Consequently, the CFPB operates as a co-regulator

⁷⁴ Supra, note 72, (Barr), 8

⁷⁵ Adam Levitin, ‘The Consumer Financial Protection Bureau: an introduction’, (2013) 32 Boston University Review of Banking and Financial Law, 321, 329

⁷⁶ Elizabeth Warren, ‘Unsafe at any rate’, (Summer 2007), Democracy, Issue No. 5, “If it’s good enough for microwaves, it’s good enough for mortgages. Why we need a Financial Product Safety Commission.” Her analysis paralleled that of earlier consumer product safety campaigners such as Ralph Nader and his criticism of the US car industry and the creation of the Consumer Product Safety Commission in 1972, Ralph Nader, *Unsafe at any speed*, (Knightsbridge Publishing, Mass, 1965)

⁷⁷ CFPB website, ‘Strategic Plan, 2013 - 2017’, (April 2013), <http://www.consumerfinance.gov/strategic-plan/>, (accessed 24th July 2017)

⁷⁸ Supra, note 75, (Levitin), 338

with State authorities. Recognising this, their respective roles are governed by a memorandum of understanding (MoU) between the CFPB and the Conference of State Bank Supervisors.⁷⁹ While the issue of CFPB and State regulation of banks is covered by the MoU there is no equivalent arrangement for mortgage intermediaries. This issue is considered later in this chapter.

The regulator has already levied large fines using its enforcement powers in areas outside its mortgage remit.⁸⁰ John Coffee has considered the possible role of regulatory enforcement and private litigation in the development of the securities market in the US.⁸¹ There is no equivalent research for mortgage markets. Paradoxically, prior to the establishment of the CFPB, there appears to have been a false confidence in the US mortgage market. The financial crisis changed this view and it now appears that regulatory action is very relevant and necessary to the mortgage industry where compliance is “dependent on supervisory enforcement policy and record.”⁸² Any “knowing violation can result in a civil penalty of up to \$1m per day.”⁸³ For example, in November 2013 Castle & Cooke Mortgages paid penalties and consumer restitution of over \$13 m following CFPB action. The firm had broken CFPB regulations by paying “bonuses to loan officers who

⁷⁹ CFPB website, ‘State supervisory coordination framework’, (7th May 2013), http://files.consumerfinance.gov/f/201305_cfpb_state-supervisory-coordination-framework.pdf, (accessed 24th July 2017)

⁸⁰ CFPB website, ‘CFPB orders GE Capital to pay \$225 million in consumer relief for deceptive and discriminatory credit card practices’, (19th June 2014), <https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-ge-capital-to-pay-225-million-in-consumer-relief-for-deceptive-and-discriminatory-credit-card-practices/>, (accessed 27th June 2017)

⁸¹ John Coffee, ‘Law and the market: the impact of enforcement’, (2007), Columbia Law and Economics Working Paper No. 304. There is some correlation between enforcement and litigation on confidence in the market. Coffee does not go as far as, for example, Rafael La Porta and others, ‘Law and finance’, (1998), 106 *Journal of Political Economy*, 1113, 1152-1152, “countries whose legal rules originate in the common-law tradition tend to protect investors considerably more than the countries whose laws originate in the civil-law, and especially the French-civil-law, tradition...Law enforcement is strong in common-law countries as well, whereas it is the weakest in the French-civil-law countries.” It may well be that countries with an active legal and regulatory system enjoy higher economic growth. “legal and regulatory systems that give a high priority to creditors have better functioning financial intermediaries than countries where the legal system provides much weaker support to creditors.”, Ross Levine, ‘Law, finance, and economic growth’, (1999), *Journal of Financial Intermediation* 8, 8–35

⁸² Vincent Di Lorenzo, ‘Barriers to market discipline: a comparative study of mortgage market reforms’, (2012), 29 *Arizona Journal of International and Comparative Law*, 517, 552

⁸³ Discussed in Laureen Galeoto and others, ‘The Consumer Financial Protection Bureau: the new sheriff in town’, (2012) 129 *Banking Law Journal*, 702

placed consumers with mortgage loans that had higher interest rates.”⁸⁴ Nevertheless, the CFPB, as a regulatory institution has still to establish its claim to “institutional legitimacy”. It is perceived as lacking both accountability in governance and financial terms since it is run by one man (until recently Richard Cordray) and not by a board and it takes its funding direct from the Federal Reserve not from a Congressional allocation of funds.⁸⁵ Some aspects of Congressional concerns are considered in the next section.

The establishment of the CFPB can be seen as evidence of the US catching up with some other countries.⁸⁶ It presents a number of conceptual challenges to the US approach to conduct of business financial regulation. US regulation now requires that one party to a contract has to look after the interests of another more weakly positioned contractor reflecting a “proto-fiduciary duty which changes the consumer debtor/creditor relationship.”⁸⁷ There will consequently be two outcomes: an increasingly “paternalistic regulatory mindset ... and [the] reduction/rationing [of] mortgage credit”.⁸⁸ This perception may reflect a more “libertarian” and, possibly, financial services’ industry view. It also reflects a view that Federal regulation may be inhibiting the aspiration of homeownership, the importance of which was considered earlier in this chapter. Pottow quotes two Congressmen that the position will be that of the government saying to a potential homeowner that your access to the “American Dream” is denied since we the government are “smarter than you” and “we have to protect you from yourself”.⁸⁹

Congressman Jeb Hensarling, a Texas Republican, has been chairman of the House of Representatives’ Financial Services Committee since 2012. He is critical of the CFPB. For example, he has said that his “number one goal has been more jobs and a healthier economy for all. That means we’ve got to root out the job-choking red tape that hurts our

⁸⁴ CFPB website press release, ‘CFPB Takes Action Against Castle & Cooke For Steering Consumers Into Costlier Mortgages’, (7th November 2013), <http://www.consumerfinance.gov/newsroom/cfpb-takes-action-against-castle-cooke-for-steering-consumers-into-costlier-mortgages/>, (accessed 24th July 2017). For an example of the process see Sandra Hauser, ‘Lessons learned from the first public CFPB enforcement action and bulletin 2012-06’, (2012) 66 Consumer Financial Law Quarterly Report, 395

⁸⁵ David Carpenter, ‘The Consumer Financial Protection Bureau: a legal analysis’, (14th January 2014), Congressional Research Service

⁸⁶ John Pottow, ‘Ability to pay’, (2011), 8 Berkeley Business Law Journal, 175-208, 193

⁸⁷ Ibid, (Pottow), 205

⁸⁸ Ibid, (Pottow), 205

⁸⁹ Ibid, (Pottow), 205, quoting Representatives Neugebauer and Hensarling

economy, stifles competition, and erodes free enterprise...[and] protecting American consumers by holding Washington accountable. One of those Washington regulators is the CFPB – perhaps the most powerful and least accountable government agency in the history of the republic. The CFPB and its unelected director were given unbridled, discretionary power over everyday financial products....Not only does this agency have the power to make these products less available and more expensive, it has the power make them completely unavailable.”⁹⁰

However, from a social cohesion perspective the lack of an ability-to-repay regulatory regime may result in “reverse redlining” with high-risk mortgages being concentrated in “low-income and minority communities” with a “confluence of public policy wishing to regenerate deprived areas and intermediaries and lenders keen to provide high margin loans.”⁹¹ It has been argued that during a downturn the process may go into reverse and these same areas are likely to be the worst affected.⁹² In other words the increase in homeownership is illusionary.⁹³

However, despite the establishment of the CFPB it is still not clear that the actions taken to date will be sufficient to prevent further problems in the retail mortgage industry. The over-reliance on information disclosure and role of mortgage brokers are considered in the next sections. Nevertheless, it is worth noting that failures in the area of conduct of business happen quickly. It is apparent that underwriting standards in the US fell very quickly over a very short period mainly between 2005 and 2006.⁹⁴ Consequently, it is questionable whether supervisors, using data which may be several months old, will be able to identify issues and act quickly enough.

⁹⁰ Jeb Hensarling web-site, speech in Athens, Texas on 27th April 2014, <https://hensarling.house.gov/media-center/in-the-news/the-monitor-hensarling-fights-for-east-texans>, (accessed 14th July 2017)

⁹¹ Eric Belsky and Susan Wachter, ‘The public interest in consumer and mortgage credit markets’, (2010) Research Paper No. 10-05 Institute for Law and Economics, University of Pennsylvania Law School, 14. In 2009 mortgage lending to non-Latino whites fell by 17% while the equivalent fall for Latinos was 63% and African-Americans was 60%, Greg Jones, ‘Mortgage lending: confusing in every language’, (2012) 24 Loyola University of Chicago School of Law, Consumer Law Review, 661

⁹² Ibid, 15

⁹³ Ibid, 23

⁹⁴ Chapt 3, n137, (Demyanyk and Van Hemert), 33

In addition, little work has been undertaken on the role of non-deposit taker mortgage lenders.⁹⁵ There may be a correlation between the entry of non-deposit takers into the mortgage market and the decline in underwriting standards.⁹⁶ Despite having a large share of the subprime market these lenders largely fell outside regulatory supervision since they did not accept deposits. It is possible that “innovative corporate structures and financial instruments” will again be designed to circumvent and to reduce active supervision.⁹⁷ Moreover, often it is the regulations themselves that drive lender strategies. For example, banning prepayment penalties may have encouraged borrowers to use their homes as cash-machines by taking equity from their property and increasing the LTV with no cost with the consequence that they were far more vulnerable to a property price downturn making default more likely.⁹⁸ Ultimately, borrowers will need to be equipped to look after their own interests and part of the regulatory strategy is to ensure that they are provided with sufficient information in an easy format to enable them to exercise their own best judgement.

5.7 The failure of disclosure

In the US there have been many initiatives, over the decades, to ensure that adequate information is provided to consumers in advance of their committing to a mortgage.⁹⁹ However, there is evidence that consumers presented with too many options will default to

⁹⁵ William Francis, ‘UK deposit-taker responses to the financial crisis: what are the lessons?’, (2014) Bank of England, Working Paper No. 501

⁹⁶ Yuliya Demyanyk and Elena Loutskina, ‘Mortgage companies and regulatory arbitrage’, (2013), ssrn 2051001, 4. This paper sets out the results of empirical research comparing the use of less regulated non-deposit taking banking group subsidiaries to write the high risk mortgage loans. This enabled banking groups avoid loan loss recognition and higher capital charges. See also Jihad Dagher and Ning Fu, ‘What fuels the boom drives the bust: regulation and the mortgage crisis’, (2012) ssrn 1728260

⁹⁷ Ibid, (Demyanyk and Loutskina), 29

⁹⁸ Todd Zywicki, ‘The behavioral law and economics of fixed-rate mortgages (and other just-so stories)’, (January 2014), Supreme Court Economic Review, Vol. 21, No. 1, 157-214 and Steven Laufer, ‘Equity extraction and mortgage default’, (2013) Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs Federal Reserve Board, Washington, D.C., 3, who estimated that borrowers of some 30% of homes purchased between 2000 and 2003 defaulted due to “equity extraction”

⁹⁹ This was originally set out in the Truth In Lending Act in 1968 and amended several times since (see *supra*, note 43) and *supra*, note 37, (Woodward and Hall), 4

inaction and leave decision making to an intermediary.¹⁰⁰ As early as 2002 Engel and McCoy discredited consumer protection views' on disclosure which underpinned US legislation in this area going back to the 1960s and 70s.¹⁰¹ Similarly, Renuart and Thompson were critical of the ability of consumers to understand much of what is disclosed in mortgage literature, citing a number of studies including one in which a quarter of consumers were unable to identify the cheapest mortgage even after the disclosure requirement had been improved.¹⁰² Research indicates that due to "bounded rationality" and the dominating desire of consumers to buy their home they will discount information on the risks of borrowing.¹⁰³ The 2002 US National Adult Literacy Survey found that 96% of adults could not work out the interest charge on a \$10,000 mortgage with all the statutory information provided and yet described themselves as financially literate and numerate.¹⁰⁴ In addition, mortgage applicants tended to pay less attention to future costs, ignore future risks and concentrate on the monthly payment element of a loan and exclude other aspects such as early repayment costs and various fees and other expenses.¹⁰⁵ There is also an over-emphasis on small numbers. For example, applicants focused on "differences between \$100 and \$200" but were less concerned by differences between \$1100 and \$1200".¹⁰⁶ The "mental ruler" is closer to a "logarithmic scale" and does not allow for equal spacing between numbers.¹⁰⁷ There was also a belief that mortgages were

¹⁰⁰ Ian Ayres, 'Homo economicus, homo myopicus and the law and economics of consumer choice: menus matter', (2006) 73 University of Chicago Law Review 9

¹⁰¹ Kathleen Engel and Patricia McCoy, 'A tale of three markets: the law and economics of predatory lending', (2002), Texas Law Review 80, No.6, 1255-1381, 1275

¹⁰² Elizabeth Renuart and Diane Thompson, 'The truth, the whole truth, and nothing but the truth: fulfilling the promise of truth in lending', (2008) 25 Yale Journal of Regulation, 181-245, 196

¹⁰³ Andrea Boyack, 'Lessons in price stability from the US real estate market collapse', (2010) Michigan State Law Review, 945. "Bounded rationality" is used to describe individuals who in undertaking economic decisions will not attempt all the necessary rational calculations to determine the best path but will instead use what information they have and employ a range of broad assumptions to make up their mind, in the time available, to come to a view that satisfies their immediate objectives but may not be the best objective approach and decision, Daniel Kahneman, 'Maps of bounded rationality: a perspective on intuitive judgement and choice', Nobel Prize Lecture, 8th December 2002

¹⁰⁴ Cited in Lauren Willis, 'Decision making and the limits of disclosure: the problem of predatory lending', (2006) 65 Maryland Law Review 707

¹⁰⁵ Ibid, (Willis), 738

¹⁰⁶ Ibid, 739

¹⁰⁷ Ibid, 739

subject to more regulation than was actually the case and this view appeared to be sustained by the level of mandated regulatory disclosure.¹⁰⁸

In the UK the Financial Services Authority's (FSA) research found that consumers tended to focus on the immediate mortgage payments making neither "long-term assessment of the suitability [or] the value of the product".¹⁰⁹ However, the CFPB has also carried out consumer testing of its mortgage disclosure document: "Know before you owe" and found that consumers value this information.¹¹⁰ Additional research supported the view of the CFPB.¹¹¹ It is worth noting however, that evidence suggests that the more complex mortgage were "disproportionally used by sophisticated, high-income, prime credit score customers."¹¹² Nevertheless, recent research in cognitive psychology does not support the efficacy of product disclosure.¹¹³ In conclusion, clear and concise consumer information is important and should be a regulatory objective. However, it may be an error to place much reliance on this aspect of regulation as a bulwark of consumer protection.¹¹⁴ As has been seen the evidence strongly indicates that many borrowers cannot be trusted to make

¹⁰⁸ Ibid, 740

¹⁰⁹ FSA, 'Mortgage Effectiveness Review: stage two report', (March 2008), 34. See Chapter 2 for further discussion.

¹¹⁰ Cordray, Richard, 'Know before you owe', remarks at field hearings, Des Moines, Iowa, 23rd November 2013

¹¹¹ Supra note 37, (Woodward and Hall). See also Sumit Agarwal and others, 'Do consumers choose the right credit contracts?', (2006), ssrn 943524, 17

¹¹² Gene Amromin and others, 'Complex mortgages', (November, 2010) Federal Reserve Bank of Chicago, WP 2010-17, 3-4

¹¹³ Jessica Choplin and Debra Stark, 'Doomed to failure: a psychological analysis of mortgage disclosure and policy implications', (2013), 32 No.10 Banking and Financial Services Policy Report, 1. The paper talks of the "Gricean norm of quantity" ("the assumption that all important things are included and all those that are not important are omitted as a conversational norm but mortgage brokers sometimes break this norm."). Consumers tend to "skim disclosure forms looking for info which confirms what they have been told ("confirmatory test strategy")." There is also "part-set cueing" where the consumer tries to recall a set of information which is made more difficult when they are given part of the list and has to remember the rest. "The borrower knows that there are important items they have to check on a form (eg APR, monthly payments, adjustable rates, term and interest changes during the terms etc). If the broker mentions one or two of these things the borrow will have problems remembering the rest."

¹¹⁴ Hooman Estelami, 'An ethnographic study of consumer financial sophistication', (2014) Journal of Consumer Behaviour, 13, 328, 335, with empirical evidence of the "bandwagon effects" where consumers based their financial decisions on what others had done: a form of "following the herd" and including "unidimensional decision making" where the consumer focused on only one element in making a financial decision as a means of dealing with complexity. See also Gregory Elliehausen, 'Implications of behavioral research for the use and regulation of consumer credit products', (2010) Finance and Economics Discussion Series, Federal Reserve Board, Washington, D.C., 31

correct borrowing decisions in their own interest. They struggle with simple arithmetic and place considerable reliance on lenders and brokers for advice. Focusing on TILA it is possible that the disclosures required by regulation “commonly reflect politicians’, lawyers’, and economists’ beliefs about solutions to problems” rather information that is meaningful to consumers.¹¹⁵ It is possible that a more innovative approach can be taken using symbols and signs to convey important information.¹¹⁶

The US State of Illinois attempted to apply a paternalistic approach to mortgage lending in 2005 requiring sub-prime mortgage borrowers to undertake debt counselling if they wished to borrow using a high-risk mortgage product.¹¹⁷ The independent counsellors were required to check the ability of individual borrowers to afford the mortgage. However, the legislation only applied to state licensed lenders and was limited to a four-year pilot in parts of metropolitan Chicago.¹¹⁸ Over the course of the pilot some 1,200 borrowers were counseled and the results assessed. In almost 10% of cases there were indications of fraud and in approximately half of all cases customers were advised that they clearly could not afford the loan or were on the cusp of affordability.¹¹⁹ The vast majority of sub-prime lending was undertaken by the state-licensed lenders and there was a significant correlation between the reduced volume of lending in areas subject to the pilot and those outside its operation.¹²⁰ The pilot was ended abruptly after only twenty weeks following litigation and protests by community activist groups and residents on the grounds that it was racially discriminatory.¹²¹ This pilot tends to support the view that market discipline cannot be relied upon and even with all the information clearly presented there are limits to which individual borrowers can be trusted to make responsible decisions.

¹¹⁵ Federal Trade Commission, ‘Improving consumer mortgage disclosures: an empirical assessment of current and prototype disclosure forms’, (2007), Bureau of Economics Staff Report, 121. There were similar finding in Nicholas Wonder, Wendy Wonder and David Fewings, ‘The financial rationality of consumer loan choices: revealed preferences concerning interest rates, down payments, contract length and rebates’, (2008), *The Journal of Consumer Affairs*, Vol. 42, No. 2, 243

¹¹⁶ Luca Cian, Aradhna Krishna and Ryan Elder, ‘A sign of things to come: behavioral change through dynamic iconography’, (2015) *Journal of Consumer Research*, Vol. 41, No. 6, 1426

¹¹⁷ Sumit Agarwal and others, ‘Do financial counseling mandates improve mortgage choice and performance? Evidence from a legislative experiment’, (October 2009) Federal Reserve Bank of Chicago Working Paper 2009-07, 6

¹¹⁸ *Ibid*, 7-8

¹¹⁹ *Ibid*, 9

¹²⁰ *Ibid*, 19. See chapt 7 n44 for the Di Maggio and Kermani research

¹²¹ *Ibid*, 9

As discussed in chapter 4, the FCA has already come to this conclusion and adopted a paternalistic regulatory approach. The UK approach could be seen as going beyond paternalism and moving towards a form of “consumer infantilism” where the borrower takes little or no responsibility. The US approach is more balanced, albeit buttressed by the threat of severe enforcement and private litigation risk. Yet, at the same time, the regulations steer all parties toward the “safe harbour” of standard term and lower, but not risk free, mortgages. However, this approach rests on the adequate supervision of mortgage intermediaries; the subject of the next section.

5.8 The regulation and supervision of mortgage intermediaries

As already mentioned, mortgage intermediaries have a central role in the mortgage sales process. For some 60% of mortgages sales, borrowers will primarily deal with the intermediary not the lender. It is likely that the first evidence of serious failures in the underwriting process or gaps in the ability to repay assessment will be found in the mortgage intermediation system. As mentioned earlier the current US regulatory system divides the regulation and supervision of mortgage intermediaries between States and the CFPB. The latter sets minimum standards on disclosure of information, non-discriminatory policy and ability to repay regulations. Everything else, including the licensing of intermediaries, is a matter for individual States.¹²² Too often this is restricted to basic licencing procedures covering criminal record checks and training requirements with little proactive supervision of individual broker conduct.¹²³ The CFPB appears to have limited its own role in this area and has not sought to become involved with how intermediaries interact with borrowers.¹²⁴ Moreover the CFPB does not appear to seek information from State supervisors on what is happening at a local level in the mortgage origination market.¹²⁵ It is possible that this approach has been adopted to make the best use of

¹²² Mortgage Nationwide Licensing System, ‘Mortgage industry report’, (Q2 2015 Update), 402,468 individuals and 10,149 companies were licensed by Federal bodies (eg Federal Reserve, Office of the Comptroller of the Currency and FDIC while at State level 36,563 companies, 45,873 branches and 351,940 individuals were licensed as mortgage originators)

¹²³ Keith Ernst, Debbie Bocian and Wei Li, ‘Steering wrong: brokers, borrowers and subprime loans’, (8th April 2008), Centre for Responsible Lending, 8

¹²⁴ CFPB, ‘Supervisory highlights’, (Fall 2015), Issue 9

¹²⁵ CFPB, ‘Semi-annual report’, (Spring 2015)

limited resources.¹²⁶ In addition, the conceptual structure of US regulation leaves local regulation and supervision to individual States while regulation at a national level falls to Federal agencies.¹²⁷ Clearly there are risks; for example, States working in their own interest contrary to the national objectives, the “capture” of States by local interest groups, uncoordinated actions and the expectation that the nation state will pay for local individual State failures. Nevertheless, State-level experimentation is a missed opportunity.¹²⁸ It is possible that States are experimenting with innovative forms of regulation and supervision which may be usefully employed more widely and States may well have information on market practices which could be disseminated across the country. For example, Washington State’s Department of Financial Institutions, which supervises aspects of the operations of mortgage originators, issues regular “best practice” statements on mortgage intermediaries.¹²⁹ Other States do the same. The CFPB is in a unique position to undertake this coordination role and to assess the efficacy of each approach without stepping on State prerogatives.

5.9 Conclusion

This chapter primarily considers the importance of understanding the recent major changes to mortgage conduct of business regulations in the context of the overwhelming desire in the US to support a broad popular aspiration to own ones’ home. This approach to regulation seeks to balance supporting wide-spread homeownership, and all the civic benefits this brings, with the need to protect both borrowers and the wider financial system

¹²⁶ As discussed in chapter 4, the FCA have adopted a similar approach and concentrate almost all their supervision resources on few lenders rather than the many intermediaries

¹²⁷ James Madison, Alexander Hamilton and John Jay, ‘The Federalist Papers’, (published 1788, Penguin Books, London, 1987). Here the authors state that the “powers delegated ... by the Federal government are few and defined. Those which are to remain in the State governments are numerous and infinite...The powers reserved to the several States will extend to all the objects which... concern the lives, liberties and properties of the people [of that State].” (page 296)

¹²⁸ Federalism is often seen as encouraging economic development via competition between States within the federalist system. See Friedrich Hayek, ‘The economic conditions of interstate federalism’ and Charles Tiebout, ‘A pure theory of local expenditures’, quoted in Barry Weingast, ‘The economic role of political institutions: market-preserving federalism and economic development’, (1995) 11 *Journal of Law, Economics and Organization*, 1, 5. It is also seen as a control on central government appropriation of regulation best left to local bodies, Yingyi Qian and Barry Weingast, ‘Federalism as a commitment to preserving market incentives’, (1997) *Journal of Economic Perspectives*, Vol.11, Number 4, 83

¹²⁹ Department of Financial Institutions, ‘FYI financial news - updates from DFI’s Consumer Services’, (Winter 2014)

from over-borrowing. The context is a high-level of government intervention supporting access to homeownership.

First, built into the conduct of business of regulations is a level of “risk tolerance” in the interest of promoting wider homeownership for public policy reasons. It accepts that borrowers and lenders will make mistakes. This is evident in the regulatory protection given to the standardised “qualifying mortgage”. Some 23% of this type of mortgage, written just before the financial crisis, defaulted.¹³⁰ Ultimately, it is a political and regulatory decision balancing the risks to the individual of over-borrowing and the costs to the financial system against a range of socio-economic and political beneficial objectives. Whether this approach could be transferred to other jurisdictions may be difficult. It requires both political and regulatory will. In the US the benefits of homeownership are a bi-partisan objective and embedded in the legislation and form part of the “American Dream”. Regulation follows this underlying concept.

Second, the CFPB places too much faith on the efficacy of mortgage information disclosure. It is important that the potential borrower is informed in the most effective manner possible of the mortgage’s key points. However, the behavioural evidence suggests that only limited reliance can be placed on disclosure regulations.

Finally, as mentioned above, the best documentation and information may be undermined by the actions of lenders and intermediaries. The US regulatory and supervisory system attempts to balance both State-level and Federal perspectives'. Whether or not the balance is struck in the right place, it nevertheless, provides opportunities for information and best practices to be shared between States and the Federal authorities. The new regulatory approach contains built-in known risks. These need to be monitored and reported regularly to check that balanced judgements remain sound.

¹³⁰ Supra, note 66, (Chatlos), 148

CHAPTER 6

The political legitimacy of the Financial Policy Committee and its use of macroprudential policy instruments

“Do not dream that your letters of office, and your instructions...are the things that hold together the great contexture of the mysterious whole. These things do not make your government. Dead instruments, passive tools as they are, it is the spirit of the [common] communion that gives all their life and efficacy to them.”

“...without any mutual relation, the cement is gone - the cohesion is loosened - and everything hastens to decay and dissolution”.¹

6.1 Introduction

This chapter considers the issue of the threat to political legitimacy of the Bank of England’s Financial Policy Committee (FPC) and its employment of macroprudential policies.

The concept of political legitimacy is based on the underlying ideas which sustain democratic accountability and the conventions and understandings that govern the use of power. These in turn have their roots in the development of the concept of national sovereignty. This latter element and its relationship with political legitimacy are considered in this chapter.

Further, this analysis assesses the division of political legitimacy into its formal or “dignified” aspect established by “black-letter” law and the “efficient” parts used to get

¹ Edmund Burke, *Speeches on America, On conciliation with America*, (published 1775, Arthur Innes (ed), Cambridge University Press, Cambridge, 1906), 160-161

things done and accepted.² Both concepts are necessary. The first sets out the normative framework including legal procedures and institutional accountabilities and transparency. These aspects are particularly important where authority is delegated to an independent institution such as the Bank of England and the FPC. The second establishes the basis, in societal and empirical terms, of how power is exercised.

This chapter examines the issues posed, in particular, by the delegation of policymaking and implementation powers to public organisations. Further, in the context of political legitimacy it also considers the balance that needs to be struck between public transparency and maintaining the “mystic” of authority.

Besides considering these aspects this chapter examines the socio-legal perspectives of political legitimacy including the limitations imposed by unwritten conventions together with an imprecise, gray area which contains an understanding of what is societally acceptable. The term “acceptance” is used here rather than, for example, “support “ or “endorsement” since the bar is a low one: endorsement is not required; acceptance is sufficient - to do otherwise would raise issues of degrees of endorsement; “acceptance” has no voice; it is passive.

Nevertheless, public acceptance cannot be taken for granted. It is ultimately governed by the world of politics, media, public attention and criticism. It may be that the FPC and the Bank of England are “but the ‘dry trustees’ of a fealty given to others” or, alternatively, their role and independence, in practice, reinforces the concept of their sovereignty.³ These issues are considered later but first it is important to understand that they do not exist in a vacuum but have a wider context.

This chapter assesses the importance of both political and operational independence and the possession of technical expertise as factors in securing and maintaining political legitimacy. However, these are insufficient since in a number of areas, such as housing, the policymaker needs to ensure high levels of both popular and emotional engagement. This is particularly relevant since macroprudential powers are likely to have a significant influence on the aspiration of people to own their own home. Consequently, the FPC

² Walter Bagehot, *‘The English constitution’*, (published 1865-1867, Oxford University Press, Oxford, 2001), 7

³ Ibid, (Bagehot), 194

cannot rely on the usual tenets of political legitimacy. As this chapter discusses, it needs to be conscious of the power of “sentiment and reason” and the Rousseauian influence of the “general will” as part of the development and maintenance of political legitimacy. Consequently, the FPC will need to provide a strong and compelling “emotional” narrative to engage these sensibilities.

6.2 Context

As mentioned in earlier chapters, rapid increases in credit are frequently the cause of financial instability. Preceding almost all financial crises there has been a close relationship between excessive lending and a rise in property (normally retail housing) values.⁴ An increased availability of mortgages drives up the price of homes which in turn provides greater security for more lending.⁵

As set out in the introduction, this thesis has three broad themes. First that macroprudential policies have been developed, in part, as potential instruments to suppress market forces and the demand for credit. The ease of access to credit increases demand for property. Mortgages can be said to provide the “fuel” which powers the demand for housing.⁶ However, the underlying economic pressures in the system and the demand for housing remain. As discussed in earlier chapters the evidence suggests that quantitative policy measures set by the FPC, such as LTV and DTI limits, are only likely to succeed, at best, for a short period of time in the face of these economic forces which encourage the subversion of these measures. The objective of lending restrictions such as LTV and DTI limits is not to reduce demand but to limit the means by which such demand may be put into effect. It is important to note that the demand remains. Other sources of finance, abetted by willing sellers, brokers and other agents, may be sought. Consequently, market forces may defeat macroprudential policy as more credit “leaks” into the system. This is reinforced by the evidence given by Goodhart and Buiter to the Treasury Select Committee: “everyone loves [a boom] and the idea that you are going to

⁴ For example, chapt 2 n49 (Borio and Lowe), 27

⁵ Chapt 2 n52 (Waldron and Zampolli), 3-4

⁶ Kathleen Scanlon and Marja Elsinga, ‘Policy changes affecting housing and mortgage markets: how governments in the UK and the Netherlands responded to the GFC’, (2014), *Journal of Housing and the Built Environment*, 29 (2), 335-360, 336-337

have a regulator saying, “I am sorry, we are not going to have 100% or 125% loan to value ratios; Northern Rock, you are not allowed to behave that way, you are not allowed to do subprime mortgages based on nothing except the expectation that housing prices will go on rising, you are not allowed to do that,” runs counter to the wishes of the lenders, the borrowers, and virtually every politician at the time during the boom.” ⁷

The second related theme of this thesis is that macroprudential policies only address the demand side of the economic equation. Unless the supply side of providing more housing is undertaken, macroprudential policies are likely to fail. This issue is considered in chapter 8.

This chapter considers the third theme of this thesis and the concern that the use of LTV and DTI macroprudential tools may be challenged as lacking political legitimacy. This thesis is not intended to be a comprehensive analysis of the various forms of “legitimacy” but it is important to understand the concerns relating to political legitimacy which may undermine the use of quantitative macroprudential policies and the authority of the Bank of England as a policymaker.

As mentioned in the introduction political legitimacy is based on a superstructure the foundations of which rest on the concepts of sovereignty and, in particular, political sovereignty. This starting point is considered briefly in the next section.

6.3 Political sovereignty

The concept of political sovereignty can be seen as early as the 14th century with the statement that a “king ...does not recognise any superior” and does not require Papal sanction. ⁸ This was also evident shortly afterwards in 1414 at the Council of Constance with the recognition of national states with representatives from France, Italy, Germany and British Isles voting and working as national bodies.⁹ At its centre is a question of who

⁷ Charles Goodhart and Willem Buiter, Oral evidence to the TSC, ‘Run on the Rock: oral and written evidence’, (House of Commons, Fifth Report of Session 2007–08, Vol. II), answer to Question 694, 90

⁸ Len Scales, *The shaping of German identity: authority and crisis, 1245–1414*, (Cambridge University Press, Cambridge, 2012), 216-217, quoting Bishop Lupold of Bebenburg’s ‘Treatise on the rights of the Roman Kingdom and Empire’, 1339

⁹ Caspar Hirschi, *The origins of nationalism*, (Cambridge University Press, Cambridge, 2012), 82

has the power to sanction executive actions; whether these be the raising and allocation of taxes or the making of appointments to episcopal benefices. This power is not fixed but moves through a “vertical ladder” and “horizontally” from, and through, different power-bases.¹⁰

The concept of sovereignty has mutated over time and as explained by Heller, “all conceptions of law are fundamentally political and tied to particular historical and social contexts.”¹¹ Sovereign power does not just exist at the pinnacle of the society since for there to be a ruler there must also be those that are ruled: leaders require followers.¹² This was evident, for example, to the Spanish thinkers at the so-called School of Salamanca in the 16th century who saw that absolute power cannot successfully constrain market forces and that subjects will often seek, successfully, to evade, for example, price-control edicts, that affected their well-being.¹³ Similarly, Bodin recognised that sovereignty did not confer absolute power in that the ruler was still bound by some constraints whether these be customary law or “some basic laws of the body politic.”¹⁴ Consequently, sovereignty requires that it is exercised “through institutions which knitted the government and community together”.¹⁵ The foundation of sovereignty is trust which confers legitimacy and is evidenced by “acceptance”.

The need for the ruled to, at least, acquiesce to laws made by those that purport to exercise authority over them was developed further by Grotius with his concept of sovereignty as a form of trust so that “sovereignty is not a power that rulers have over

¹⁰ John Jackson, ‘Sovereignty-modern: a new approach to an outdated concept’, (2003), 97 *American Journal of International Law*, 782-802, 791-792

¹¹ David Dyzenhaus, ‘Hermann Heller’ in Arthur Jacobson and Bernhard Schlink (eds), *Weimar: a jurisprudence of crisis*, (University of California Press, Berkley, 2000), 249-279, 250

¹² Robert Wolff, *In defense of Anarchism*, (University of California Press, Berkeley, 1998), 5-6

¹³ Marjorie Grice-Hutchinson, *The School of Salamanca, readings in Spanish monetary theory*, (Clarendon Press, Oxford, 1952), 93, 111 and 116

¹⁴ Francis Hinsley, *Sovereignty*, (Cambridge University Press, Cambridge, 1986), 124. There is even a reference by Bodin to a form of Hobbesian contract in “that a prince who has contracted with his subjects is bound by his promise should be beyond all doubt”, Jean Bodin, *Six livres de la République*, (published 1576), an extract of which was published in Julian Franklin (ed and tr), *On sovereignty: four chapters from The six books of the commonwealth*, (Cambridge University Press, Cambridge, 1992), 36

¹⁵ *Ibid*, (Hinsley), 124

subjects but one that they exercise on behalf of the body corporate”.¹⁶ Hobbes went further with the possibility of replacing the ruler with an “assembly of men” following “men agree[ing] amongst themselves to submit...voluntarily” to a “Commonwealth by Institution”.¹⁷ This applies equally to government agencies. Hobbes gave as an example the administration of the treasury charged with the “economy of the Commonwealth” which “in a Democracy” acts in “the quality of a Minister of the People”.¹⁸

As the concept of sovereignty developed, Locke saw the government thus established as subject to specific “bounds” and operating under a trust on behalf of society.¹⁹ In contrast, Rousseau saw the social contract as one that “gives the body politic absolute command over the members of which it is formed; and it is this power, when directed by the general will, that bears...the name of ‘sovereignty’”.²⁰ Moreover, “the sovereign knows no person but the body of the nation”.²¹ Indeed, a legitimate government is defined as one that will “follow the general will in all things.”²²

In Britain administrative complexity increased through the 17th century with significant fiscal requirements, largely due to the need to finance wars. Consequently, more powers had to be delegated to growing administrative functions. For example, the Long Parliament’s administration of fiscal policy in England included establishing a network of public offices “to raise and spend money” and to audit the various treasury functions.²³ These administrative operations continued after the Restoration and, in due course, the Bank of England became part of a “smoothly running fiscal state”.²⁴

¹⁶ Knud Haakonssen, ‘Hugo Grotius and the history of political thought’ in Knud Kaakonssen (ed), *Grotius, Pufendorf and modern natural law*, (Dartmouth, Aldershot, 1999), 35-61, 40

¹⁷ Thomas Hobbes, *Leviathan*, (published 1651, Penguin, London, 1985), Part II, Chapter 18, 228

¹⁸ Ibid, (Hobbes), Part II, Chapters 23 and 24, 290 and 294

¹⁹ John Locke, *Second treatise of government*, (published 1689, Cambridge University Press, Cambridge, 1960), Chapter XI, 142, (363, CUP)

²⁰ Jean-Jacques Rousseau, *Social contract*, Chapter IV, (published 1762, Hafner Press, New York, 1947), 27

²¹ Ibid, (Rousseau), (page 29 in the Hafner edition)

²² Jean-Jacques Rousseau, *Discourse on political economy*, (published 1755, Hackett, Indianapolis, 2011), 128

²³ James Scott Wheeler, *The making of a world power*, (Sutton Publishing, Stroud, 1999), 199

²⁴ Ibid, (James Scott Wheeler), 214

Moreover, for the Federalists, sovereignty did not rest in anyone person or institution but rather in the “people”.²⁵ The latter have a “general spirit” which is shaped by history, “mores and manners”.²⁶ However, the idea of popular sovereignty was, in 1920s Germany, subsumed by Schmitt into the concept of the “state” itself becoming the sovereign body as if it existed as an organic, living entity with its own special “geist” and conferred with absolute power sustained by a “complete homogeneity of its people” coming with “the integration of this mass into a unified whole”.²⁷ However, this analysis leads towards a totalitarian rather than a democratic state since it denies fundamental tenets of pluralistic democracy braced by bonds of earned trust.

Trust is particularly important since, as mentioned earlier, sovereign powers usually operate through a process of granting delegated authority. If authority is delegated those in power “are weaker and exposed to greater risks” since everything depends on those to whom elements of power have been delegated.²⁸ This aspect is considered further later in this chapter. While in a Lockian sense there are limits to sovereign power so the possessors of delegated authority operate under a form of trust “bound by positive law” and in accordance with an understanding or set of conventions “for fear that it may offend the bulk of the community”.²⁹ Consequently, there are limits placed on what may be undertaken either by the democratically elected government or an agency appointed by it and these limits change over time depending on a number of factors including “economic and political circumstances.”³⁰

The need for public consent, or at least, acceptance, is a central element to this consideration of sovereignty and legitimacy. It goes beyond the formal role of a “sovereign” legislator and is influenced by a range of factors including the media. It is certainly not

²⁵ Joshua Miller, ‘The ghostly body politic: the Federalist papers and popular sovereignty’, (February 1988) *Political Theory*, Vol. 16, No. 1, 99-119, 113-114

²⁶ Charles-Louis de Secondat, Baron de Montesquieu, *The spirit of the law*, (published 1748, Cambridge University Press, Cambridge, 1989), Book 19, Chapter 4, “What the general spirit is”, 310

²⁷ Carl Schmitt, ‘Der bürgerliche Rechtsstaat (1928)’ in *Weimar: a jurisprudence of crisis*, supra, note 11, 299

²⁸ Niccolò Machiavelli, *The Prince*, (published 1532, Penguin, London, 2011), 41

²⁹ John Austin, *The province of jurisprudence determined*, (published 1832, Cambridge University Press, Cambridge, 1995), 193-194

³⁰ Claus Zimmermann, *A contemporary concept of monetary sovereignty*, (Oxford University Press, Oxford, 2014), 23

homogeneous since the “public consent” may contain a number of conflicting, unresolved issues. It is nebulous but at some point the general view may crystallise in opposition to a particular policy.

The next section explores the concept of political legitimacy in the context of public administration. The latter is undertaken under a form of trust bound by explicit law setting out the objectives, scope and processes which govern an institution’s establishment and operations and include its responsibilities to be both accountable and transparent. In addition, as already mentioned, these laws are augmented by conventions and understandings which place further limits on those operating with delegated authority.

6.4 The political legitimacy, the societal compact and its application to delegated agencies

An institution’s political legitimacy may be described as “having two aspects, the one formal or normative and the other social”.³¹ The former requires compliance with an accepted legal process while the latter “refers to a broad, empirically determined societal acceptance”.³² It is difficult to determine “societal acceptance”. In practice a number of political and non-political actors stand in as representatives of “societal acceptance”. Consequently, it is clear that “those who hold or seek political power have made a far-sighted bargain comparable to...Locke’s social compact; they have surrendered control over the nation’s validation process to various others” such as judges and an “inquisitive press”.³³

In addition, as mentioned earlier, democratic government, will also hold delegated agencies to account. This includes both how public resources have been used and how the exercise of public trust has been discharged. These normative elements of accountability are part of the process of ensuring political legitimation and are considered in the next section.

³¹ Amaryllis Verhoeven, *The EU in search of a democratic and constitutional theory*, (Kluwer Law International, The Hague, 2002), 10-11

³² Ibid, (Verhoeven), 11

³³ Thomas Franck, ‘The emerging right to democratic governance’, (1992) 86 American Journal of International Law, 46-91, 50

6.5 Democratic accountability by those holding delegated powers

In the context of those holding delegated powers, democratic institutions accountability can be defined “as an obligation owed” by the former to “account for, explain and justify [their] actions or decisions against criteria of some kind and [to] take responsibility for any fault or damage.”³⁴ Policymaking by an agency with delegated powers almost certainly needs to be undertaken by an independent, technocratic body working in the broader public interest. It would be expected to provide expertise, free from political influence and to ensure continuity and flexibility as economic, social and political changes occur.³⁵ Nevertheless, an independent agency forms part of the general public administrative process and a balance needs to be struck between its autonomy and the need for “political oversight”.³⁶

Consequently, the expectation is that such agencies will be accountable to the elected representatives for meeting their statutory objectives and how they carry out their mandates. These will be factors in establishing their democratic legitimacy and it may be said that “democratic legitimation in some respects is mediated through democratic accountability”.³⁷ In a Montesquieuian structure, accountability will be to both Parliament and the executive and, additionally, to the courts through the process of judicial review. This is the formal structure of accountability.

Accountability may take several forms including *ex ante* and *ex post* review and be supplemented by a requirement to provide regular and frequent explanations of the

³⁴ Fabian Amtenbrink and Rosa Lastra, ‘Securing democratic accountability of financial regulatory agencies – a theoretical framework’ in Richard Victor De Mulder, *Mitigating risk in the context of safety and security. How relevant is a rational approach?*, (Erasmus School of Law & Research School for Safety and Security, Rotterdam, 2008), 120

³⁵ Chiara Zilioli, ‘Accountability and independence: irreconcilable values or complementary instruments for democracy? The specific case of the European Central Bank’, in Georges Vandersanden and others (eds), *Mélanges en hommage à Jean-Victor Louis*, (University of Louvain, Brussels, 2003), 395-422, 397

³⁶ Thomas Sargentich, ‘Contemporary debate about legislative-executive separation of powers’, (1987) 72 Cornell Law Review 430-487, 441

³⁷ Supra note 35, (Zilioli), 398

agency's decisions and actions.³⁸ This latter aspects require high-levels of transparency; setting out the short and long term objectives and the tools to be used.³⁹ This information helps permit democratic oversight. For example, *ex ante* accountability includes some degree of influence on who is appointed to head the agency and a requirement to publish and explain its plans. Conversely, *ex post* accountability is closer to the organisation rendering account for what it has done and what has, or has not, been achieved. It runs parallel to corporate governance stewardship theory and is based on a high level of trust with readily measurable objectives and outcomes.⁴⁰

The chain of accountability is based on reason-giving, consultation and conformity with formal guidance and procedures. However, formal accountability may not be sufficient to sustain political legitimacy.⁴¹ In addition, as mentioned earlier, there is a less formal level of accountability to the general public; intermediated by the media, public interest groups etc. These aspects are considered later in this chapter. We live in an age of waning deference to authoritative institutions and a "distrust of authority and official discretion".⁴²

Consequently, in the context of limiting credit expansion, it is not clear, from the perspective of an ordinary borrower, why the agreement with a willing lender to borrow money to honour a contract to purchase a home should be prohibited for no reason that relates to the individual, personally, but based, instead, on some esoteric economic theory which, in any event, may well be wrong.

These concerns may be further aggravated if the policy comes from an obscure committee in a body remote from the perspective of democratic accountability: an aspect considered next.

³⁸ Supra note 35, (Zilioli), 401

³⁹ Supra note 35, (Zilioli), 404

⁴⁰ Beata Glinkowska and Boguslaw Kaczmarek, 'Classical and modern concepts of corporate governance (Stewardship Theory and Agency Theory)', (2015) *Management*, Vol.19, No. 2, 84-92, 87. See also Mark Fox and Robert Hamilton, 'Ownership and diversification: agency theory or stewardship theory', (January 1994) *Journal of Management Studies* 31, 69-81, 69

⁴¹ Robert Baldwin, Martin Cave and Martin Lodge, *Understanding regulation*, (2nd ed, Oxford University Press, Oxford, 2012), 340-343

⁴² Ibid, (Baldwin), 349

6.6 Machinery of government actions to improve accountability and transparency

As mentioned earlier, in a Lockian sense all government operates under a form of trust and accountability. Most commonly this is backward looking; considering how the institution exercised the trust bestowed on it. However, it is likely to include some form of public and formal review of its plans and intentions, often in the form of public consultations.

Departments of state are subject to a number of controls. First they are headed by government ministers. They are directly accountable to Parliament, normally via the oversight of dedicated select committees and, in addition, the formidable Public Accounts Committee (PAC) which “since Gladstone’s time” has been “known as the queen of the select committees...due to its cleansing effect in all government departments.”⁴³ It holds the latter to account for the use of public funds and resources and the PAC’s investigatory and assessment work is undertaken by the assiduous National Audit Office (NAO).

In a democratic system the delegated agency policymaker will be a creation of democratic processes. Its role, objectives, governance and accountabilities will be set out in statute. In the UK central government’s executive functions are carried out by both departments of state and a large penumbra of assorted agencies collectively known as “non-departmental public bodies” (NDPBs).⁴⁴

Independent government agencies are often “established for reasons of political expediency” but they may possess advantages, over traditional departments of state due to their particular “focus, expertise and insulation from political pressure”.⁴⁵ Delegated agencies tend to have a narrower, more focused set of objectives and, since there is less ministerial control of them, the level of “tinkering” and interference is reduced. The relevance of expertise and political insulation are considered later in this chapter. However, while NDPBs are formally legitimate their continuing “perceptual” legitimacy depends both on external factors and how they undertake their roles. Accordingly, they will

⁴³ Peter Hennessy, *Whitehall*, (Secker and Warburg, London 1989), 332

⁴⁴ Sometimes known as “arms length bodies”

⁴⁵ Geoffrey Miller, ‘Independent agencies’, (1986) *The Supreme Court Review*, 41-97, 75-76

be subject to both formal requirements and assessments and some form of conformance with societal expectations.

6.7 The practice and problems of overseeing organisations with delegated powers

The oversight of NDPBs is difficult. There are ad hoc reviews, such the Cabinet Office 2015 review of aspects of NDPB accountability and transparency.⁴⁶ There is also government guidance on how NDPBs should be established and managed including procedures to ensure their formal accountability.⁴⁷

The control can also take the form of H M Treasury determining the allocation of public resources as part of the public expenditure control process. As an anonymous official of this department is reported to have said the Treasury operates under a form of “delegated democracy ...Parliament is incapable of exercising its financial responsibilities. We must do it for them”.⁴⁸ However, NDPBs, such as the Bank of England, as a nationalised industry, may have their own resources.⁴⁹

Finally, the ability of Parliament, or one of its committees, to hold an agency to account, *ex ante*, should not be overstated. This may be because “political accountability is incident-driven” and “focused on a limited number of issues and guided by political priorities and political saliency.”⁵⁰ Moreover, a recent Public Accounts Committee (PAC) report indicates that there are “unclear lines of accountability between departments and such bodies [so that] it is not clear who to hold to account.”⁵¹ Additionally, Parliamentary committees are

⁴⁶ Cabinet Office, *Public bodies 2015*, (2015)

⁴⁷ GOV.UK website, “*Organisation types: a user guide*”, (updated June 2014), <https://insidgovuk.blog.gov.uk/2014/01/13/gov-uk-organisation-types-a-user-guide/>, (accessed 9th December 2016)

⁴⁸ *Supra* note 43, (Hennessy), 397

⁴⁹ Bank of England Act 1946. The NAO has recently been granted powers to assess the Bank of England, s11 Bank of England and Financial Services Act 2016

⁵⁰ Madalina Busuioc, *European agencies: law and practices of accountability*, (Oxford University Press, Oxford, 2013), 252

⁵¹ House of Commons Committee of Public Accounts, ‘Departments’ oversight of arm’s-length bodies’, Twenty-first Report of Session 2016–17, published 21st October 2016, HC 488, 5. There currently some 460 such bodies in the UK described as arising through “accidents of history”, (4 and 8 of PAC report)

likely to find that many issues may be too conceptual and devoid of hard evidence and, consequently, not amenable to committee assessment. Further, they may lack sufficient time, resources, inclination and expertise to undertake the work.

Accountability may also operate through a process of “Institutionalisation” which “implies that all the participants in a political process understand and accept the rules of that process” and all operate within unspoken limits.⁵² This has been developed further into a “dialogue model” between independent agencies and political institutions, where the former inform themselves about “the intentions, wishes and opinions of the political leadership” and use this information to conform their approach to policymaking by setting self-imposed limits.⁵³ All parties have a collective interest in, and a wish to maintain, the political and institutional structure and understand the boundaries around the exercise of their power. Consequently, they will avoid saying or doing anything that seriously challenges these constraints.⁵⁴

Finally, accountability also rests on the adequate provision of information and the transparency of the institution and its decision making. However, there may be limits in these areas and these are considered next.

6.8 Preserving the “mysteries”: the argument against transparency

Accountability is buttressed by the provision of information, which helps render the agency, and its actions and decisions, transparent and capable of scrutiny.⁵⁵ However, transparency may not always be a virtue and may hinder the work of financial supervision.⁵⁶ Ensuring financial stability and the detailed supervision of banks and other

⁵² Michael Gorges, ‘The new institutionalism and the study of the European Union: the case of the social dialogue’, (2001), *West European Politics*, 24:4, 152-168, 155

⁵³ Udaibir Das and Marc Quintyn, ‘Financial crisis prevention and management: the role of regulatory governance’, in Robert Litan, Michael Pomerleano and Vasudevan Sundsrarajan (eds), *Financial sector governance: the roles of the public and private sectors*, (World Bank/IMF/Brookings Publications, Washington DC, 2002), 163-208, 166

⁵⁴ Marc Quintyn and Michael Taylor, ‘Regulatory and supervisory independence and financial stability’, (2002) IMF Working Paper WP/02/46, 30

⁵⁵ Rosa Lastra and Heba Shams, ‘Public accountability in the financial sector’, in Eilís Ferran and Charles Goodhart, (eds), *Regulating financial services and markets in the twenty-first century*, (Hart Publishing, Oxford, 2001), 165-188, 172

⁵⁶ Oral evidence by Mervyn King to the TSC, answers to questions 21 and 62, *supra*, note 7.

significant financial institutions forms the central part of the Bank of England's regulatory policy role. How these policies and powers operate is both transparent and are, at the same time, hidden behind a facade of omniscient expertise sustained by all the attributes of authority. It is based on a certain aloofness and is surrounded by an aura of mystery.

As Bagehot explains, in a similar context, symbols are important in sustaining legitimacy and that it is important that "we must not let in daylight upon magic".⁵⁷ It may threaten the "mystic" of the policymaking institution. In many ways it forms an "arcana imperii" or "the unspoken concepts behind the exercise of authority".⁵⁸ There are two forms of symbolism important in sustaining political legitimacy: that which accrues to the organisation itself and the "power of symbolic process".⁵⁹ Both the process and the entity itself need to maintain and enhance their "mystery". Indeed, Lipset saw the principal factors determining political legitimacy as a mix of history and the "continuities of symbols and statuses."⁶⁰

The esoteric world of macroeconomic policy and microprudential supervision help sustain the "mystery". However, while the requirement for legal process, accountability and transparency cannot be doubted they may not be sufficient. All this reinforces the concern that political legitimacy is always finely balanced and cannot, at any point, be taken for granted. There needs to be more; whether it be broad public support, or at least, acceptance of the political legitimacy of, in this case, the delegated policymaker. The next sections develops these concerns from the socio-legal point of view.

6.9 Political legitimacy: a socio-legal perspective

As mentioned earlier the classical explanations of political legitimacy, expressed notably by Hobbes and Locke, are based on a social contract or agreement buttressed by democratic accountability.⁶¹ Weber analysed this further and developed a concept of societal legitimacy. He viewed legitimacy based both on an objective need for

⁵⁷ Supra, note 2 (Bagehot), 54

⁵⁸ Tacitus, *The annals of Imperial Rome*, Book II.36, (Michael Grant (tr), Penguin, London, 1956), 94

⁵⁹ Benno Netelenbos, *Political legitimacy beyond Weber: an analytical framework*, (Palgrave Macmillan, London, 2016), 132

⁶⁰ Seymour Lipset, *Political man*, (Mercury Books, London, 1959), 83

⁶¹ See, for example, Heinrich Triepel, 'The law of the state and politics' in *Weimar: a jurisprudence of crisis*, supra note 11, 187

conformance with, for example, legal procedure and, additionally, a subjective “belief in the legitimate authority of the source imposing” the obligation.⁶² Others, such as Beetham conclude that political legitimacy needs to be founded on “shared beliefs” as well as compliance with legal process stating that “political legitimacy [is] based on: legal process, expressed consent and via shared belief.”⁶³ Additionally, it requires an understanding of moral obligation and the concepts of reciprocity or “fair play”.⁶⁴ It includes corresponding, beliefs grounded on “an ideal of fraternity” and based on a general desire of “well-being” for all.⁶⁵

In the area of regulation, Weber’s concept of political legitimacy, which focuses on the subjective psychological connection between authority and obedience, may be too limited.⁶⁶ In sociological terms “legitimacy” has been defined as meaning a “generalized perception or assumption that the actions of the entity are desirable, proper or appropriate.”⁶⁷ However, this form of definition is too broad and requires a high degree of subjectivity to be useful. Moreover, it is unclear who provides this “generalized perception” and how it is ascertained, measured and preserved and whether it can only be judged with hindsight. Nevertheless, the concept of a “general consensus” is considered further in the next section.

6.10 The “sluice gate” or structuralist approach to political legitimacy

Habermas, quoting Johannes Winckelmann’s development of Weber, did not see that legal procedure was sufficient to establish political legitimacy but rather that the latter needed to

⁶² Max Weber, *The theory of social and economic organization*, (published 1925, The Free Press, New York, 1947), 131-132

⁶³ David Beetham, *The legitimation of power*, (Macmillan, London, 1991), 20-21

⁶⁴ Ronald Dworkin, *Law’s empire*, (Hart Publishing, Oxford, 1998), 190-200

⁶⁵ John Rawls, *Theory of justice*, (Oxford University Press, Oxford, 1999), 90-91. See also Michael Sandel, *Liberalism and the limits of justice*, (published 1982, Cambridge University Press, Cambridge, 1999), 34-35, which considers the meaning of “well-being”

⁶⁶ Roger Cotterrell, *Law’s community: legal theory in sociological perspective*, (Oxford University Press, Oxford, 1997), 157-158. See also Louis Pauly, *Who elected the bankers? Surveillance and control in the world economy*, (Cornell University Press, Ithaca, New York, 1997), 22

⁶⁷ Mark Suchman, ‘Managing legitimacy: strategic and institutional approaches’, (1995) *The Academy of Management Review*, Vol. 20, No. 3, 571-610, 574

be “grounded” on a “general consensus”.⁶⁸ Developing the views of Bernhard Peters, Habermas saw public policy legitimacy as dependent on the responsiveness of the policymakers to external, public views and that these are controlled by a system of “sluice gates” which open to allow public pressure to bear on policy formation.⁶⁹ He took a “structuralist” view of political legitimacy where decisions are based on negotiations. It contains within it the unspoken assumption that by following this procedure political legitimacy is established and that there is no room for further dissent.⁷⁰

6.11 The additional need for shared values and beliefs

All these models accept that political legitimacy must be based on legally accepted processes. However, they require something else which, in many ways, is closer to the views of Hobbes and Locke and the need for a broader level of public consent or, at least, acceptance. In addition, there are those who consider that political legitimacy also requires a level of “shared beliefs and values” since these are also necessary to establish “substantive legitimacy” above and beyond compliance with “procedural legitimacy”.⁷¹

To an extent this develops Rousseau’s view that while law is “a ‘celestial voice’ that dictates the precepts of public reason to every citizen” there also needs to be a “unity of sentiment and reason ...as a condition of the possibility of forming a genuine general will”.⁷² Rousseau also draws a sharp distinction between general laws which express “la volonté générale” and decrees promulgated by the executive and its agencies. The latter “may be considered to be an indirect expression of the general will so long as the people as a whole do not thwart them.”⁷³

⁶⁸ Jürgen Habermas, *Legitimation crisis*, (published 1973, Polity Press, Cambridge, 1988), 99

⁶⁹ Jürgen Habermas, *Between facts and norms: contributions to a discourse theory of law and democracy*, (Polity Press, Cambridge, 1996), 354-359

⁷⁰ James Bohman, ‘Complexity, pluralism and the constitutional state: on Habermas’s Fraktizität and Geltung [‘Between facts and norms’]’, (1994) 28 *Law and Society Review*, 897-930, 921

⁷¹ Michael Barnett and Martha Finnemore, *Rules for the World: international organisations in global politics*, (Cornell University Press, Ithaca, New York, 2004), 166-167

⁷² David James, ‘Rousseau on needs, language and pity: the limits of ‘public reason’’, (2011) *European Journal of Political Theory*, 10(3), 372–393, 374 and 389

⁷³ Ethan Putterman, *Rousseau, law and the sovereignty of the people*, (Cambridge University Press, Cambridge, 2011), 28

Evans describes legitimacy in this context as being based on the “ability to combine a Weberian bureaucratic insulation with [an] intense connection to the surrounding social structure”.⁷⁴ Seabrooke sees this “social embeddedness” through the lens of “economic constructivism” where individuals and institutions in society determine political legitimacy based on an “interaction between ideas, norms and interests.”⁷⁵ This is developed by Blyth into a need for “causal stories” or narratives to cement new ideas into the beliefs of society to justify and legitimate the actions of government agencies.⁷⁶ While Schmidt was concerned with how public policies “resonate with citizens’ substantive values and identity as well as how they fit with their interests.”⁷⁷

The need to satisfy both the process of law-making and public values and expectations are considered further in the next sections.⁷⁸

6.12 “Input and output” and “foreground and background” political legitimacy

Scharf described a distinction between “legitimacy as based on inputs” including the process used to create laws and regulations and “output legitimacy [which] is instead concerned with the problem-solving quality of the laws and rules, and has a range of institutional mechanisms to ensure it.”⁷⁹ Both elements were “necessary for democratic legitimization.”⁸⁰ Similarly, Seabrooke describes two types of legitimacy: “foreground”,

⁷⁴ Peter Evans, *Embedding autonomy: states and industrial transformation*, (Princeton University Press, Princeton, 1995), 50

⁷⁵ Leonard Seabrooke, *The social sources of financial power: domestic legitimacy and international financial orders*, (Cornell University Press, Ithaca, New York, 2006), 34

⁷⁶ Mark Blyth, *Great transformations: economic ideas and institutional change in the Twentieth Century*, (Cambridge University Press, Cambridge, 2002), 37-38

⁷⁷ Vivien Schmidt, ‘Democracy and legitimacy in the European Union revisited: input, output and ‘throughput’’, (2013) *Political Studies*, Vol. 61, 2-22, 11

⁷⁸ In Rousseau’ view public “opinion” was paramount (“sur-tout de l’ opinion”) and “legislators should be highly circumspect” of such opinion, *supra*, note 73, (Putterman)

⁷⁹ Fritz Scharpf, *Governing in Europe: effective and democratic?*, (Oxford University Press, Oxford, 1999), 7-21

⁸⁰ *ibid*, (Scharpf), 11-13

based on process and law, and “background” which is found in the “political realm” with legitimacy conferred by a “social constituency”.⁸¹

Schmidt develops Scharpf’s views on political legitimacy further. Her view of political legitimacy “relates to the extent to which input politics, throughput processes and output policies are acceptable to, and accepted by, the citizenry, such that citizens believe that these are morally authoritative and they therefore voluntarily comply with government acts even when these go against their own interests and desires.”⁸² For Schmidt “output legitimacy requires policies” to resonate “with citizens’ values and identity.”⁸³ While for Seabrooke a “legitimacy gap” occurs when “the claims made by an institution or organisation with a specific policy function are rejected... [by] those being governed.”⁸⁴ Moreover, public opinion may be influenced by how its expectations are satisfied. This is considered next.

6.13 Political legitimacy based on satisfying demands and “facilitating expectations”

Easton sees political legitimacy as based on an ability to satisfy stakeholder “demands” and public opinion as “influential in stimulating and shaping demands”.⁸⁵ Considering this further it is possible to envisage government organisations not simply as a static structures but rather as agencies subject to the stress of constant demands with their authority being tested as these demands are considered and satisfied, or not, as they flow through the system.⁸⁶

The political legitimacy of an institution and its actions is not solely an objective assessment; once achieved good for all times and circumstances. Instead the “concept is

⁸¹ Leonard Seabrooke, ‘Legitimacy gaps in the World economy: explaining the sources of the IMF legitimacy crisis’, (2007) *International Politics*, Vol. 44, Issue 2, 250–268, 253

⁸² *Supra* note 77, (Vivien Schmidt), 9-10

⁸³ *Ibid*, Schmidt, 7-8

⁸⁴ *Supra*, note 81, (Seabrooke, ‘Legitimacy gaps’), 258

⁸⁵ David Easton, *A systems analysis of political life*, (John Wiley, New York, 1965), 38-42

⁸⁶ *Ibid*, (Easton), 69

functionalised so that the question of the belief in validity can be treated as a variable” where legitimacy is dependent on circumstances and events and flows to and from the organisation.⁸⁷

Consequently, political legitimacy may depend on the ability of an organisation to “facilitate expectations”.⁸⁸ However, “expectations” are highly subjective and poses the question of whose expectations and when and in what context? The legitimacy of political actions appears to depend on the circumstance, the skill with which it is communicated and that it is “presented in a plausible way.”⁸⁹ Easton went on to say that the sense of political legitimacy may be built up and augmented among stakeholders over time and acts as a reservoir of support until the reserve is exhausted.⁹⁰

In conclusion, macroprudential policy is an aspect of public policy and consequently falls within the political domain. It requires, at least, public acceptance if not active support. However, some balance needs to be struck between clear communication and maintaining a certain level of reserve as a means of protecting the institution’s continuing authority. Nevertheless, the degree of political legitimacy invoked by an institution remains fragile, dependent on all these factors as well as the swell of events and the demands of the public. It can also be damaged by the actions of opinion formers such as the media and politicians. Consequentially, there appear to be two sets of boundary lines: one governing who may intervene in public policy and, second, how such interventions are carried out. This issue is considered further in this chapter in the context of macroprudential policy.

6.14 Political legitimacy based on managing “disappointment”

⁸⁷ Niklas Luhmann, *A sociological theory of law*, (published 1972, 2nd ed, Routledge, London, 2014), 205-206

⁸⁸ Ibid (Luhmann), 78. See also Brian Tamanaha, *Realistic socio-legal theory: pragmatism and a social theory of law*, (Clarendon Press, Oxford, 1997), 111-112. However, Tamanaha “abstains” from considering legitimacy in the round but states that each law, regulation etc will need to be considered by society in turn and accepted, or not, *A general jurisprudence of law and society*, (Oxford University Press, Oxford, 2001), 241

⁸⁹ Andreas Philippopoulos-Mihalopoulos, *Niklas Luhmann, law, justice, society*, (Routledge, Abingdon, 2010), 147

⁹⁰ David Easton, ‘An approach to the analysis of political systems’, (April 1957), *World Politics*, Vol. 9. Issue 3, 383-400, 399-400

There is a further element to sustaining political legitimacy bound-in with the economic process of allocating resources. Since not all demands for mortgage credit, housing or other social needs can be satisfied under a process of rationing scarce economic resources politics has an important role in “absorbing” or diverting unfulfilled expectations.⁹¹ It is this ability to “process disappointment” that may be seen as a true test of whether society has bestowed political legitimacy on an institution.⁹² The construction of a “narrative” is important in at least explaining, if not satisfying, these requirements and achieving and retaining societal endorsement. The theme of weaving a legitimacy narrative is considered later in this chapter but before that a number of other threads need to be drawn together.

6.15 Drawing together the threads

This section draws together the threads considered earlier and employs them to assess the extent to which aspects of macroprudential policy satisfy the requirements of political legitimacy. At its heart is the contention that macroprudential policymakers form part of a “headless fourth branch of the government” which is itself “a haphazard deposit of irresponsible agencies and uncoordinated powers”.⁹³ By its very nature macroprudential policy is political. Consequently, it must be accountable to elected lawmakers. These establish the scope of macroprudential policymaking and set its objectives. The policymaker operates under the oversight of Parliament; it renders account to the legislature and it provides regular and frequent consultations and information to ensure transparency and to engage all stakeholders in assisting in its deliberations.

In addition, as discussed above in relation to concepts of sovereignty, there needs to be an element of public consent, or at least, acceptance above and beyond that provided by the assembly of the elected representatives. This contradicts the views expressed by Woodrow Wilson in his “Study of administration”, that after the legislature has set the objectives and legal framework officials are responsible for the results and the “public must not meddle with their choices...the cook must be trusted with a large discretion as to the

⁹¹ Supra note 59, (Netelenbos), 113

⁹² Ibid, 113

⁹³ ‘*Administrative management of the Government of the United States: report of the President’s commission on administrative management*’, (1936) known as the “Brownlow Committee”, quoted in James Fessler, ‘The Brownlow Committee fifty years later’, (1987) *Public Administrative Review*, Vol. 47, No. 4, 291-296, 292

management of the fires and ovens”.⁹⁴ The exercise of discretion is central to concerns about political legitimacy: the broader and more wide-ranging the discretion the greater the risk of political challenge. This is core to macroprudential policymaking.⁹⁵ Operating close to the political legitimacy frontier macroprudential policymakers risk awakening public opposition. This is considered in the next sections.

6.16 Economics and social policy and macroprudential interventions

Macroprudential policy blurs the boundaries between economics, sociology, law and politics.⁹⁶ Such policymaking is founded on law but underpinned by economics. It does not exist as an “autopoietic system”.⁹⁷ It needs to engage and communicate with other systems based on political and socio-economic assessments and in turn influence them.⁹⁸

Macroprudential policy may, as a consequence, be undermined by political, media and interest group pressures and all these factors may, in turn, threaten the authority and the legitimacy of the macroprudential policymakers. Consequently, policies which, for example, restrict the growth of credit, may not work in the face of economic, political and social forces.

Moreover, in the socio-political sphere there is a danger that an active macroprudential policy, whether limiting access to credit or in advocating an increase in the supply of housing, may be perceived as having entered the world of political redistributive public policy. However, more broadly, almost all macroprudential or macroeconomic policy is very likely to have a social redistributive effect even if such an outcome was not intended. Nevertheless, the view is that once a perceived socio-political line had been crossed, “decisions involving significant redistributions of resources from one social group to

⁹⁴ Quoted in Marshall Breger, ‘Thoughts on accountability and the administrative process’, (Summer 1987) *Administrative Law Review* Vol.39 No. 3, 399-415, 400

⁹⁵ The Group of Thirty, *Enhancing financial stability and resilience: macroprudential policy, tools, and systems for the future*, (The Group of Thirty, Washington DC, 2010), 62-63

⁹⁶ Colin Scott, ‘Regulation in the age of governance: the rise of the post-regulatory state’ in Jacint Jordana and David Levi-Faur (eds), *The politics of regulation*, (Edward Elgar, Cheltenham, 2004), 145-174, 146

⁹⁷ Niklas Luhmann, ‘Operational closure and structural coupling: the differentiation of the legal system’, (1992) 13 *Cardozo Law Review*, 1419-1441, 1426

⁹⁸ Dimitris Michailakis, ‘Law as an autopoietic system’, (1995) *Acta Sociologica*, Vol. 38, No. 4, 323-337, 328

another cannot be taken by independent experts but only by elected officials or those that report directly” to them.⁹⁹ It is bound-in with “the existence of public aspirations...current distribution of wealth...and the inevitable role of law ... in allocating entitlements and wealth”.¹⁰⁰ The macroprudential policymaker is vulnerable since a popular mandate is absent; they were never elected to office and cannot be voted out. Procedural legal compliance and accountability may not be sufficient for the macroprudential policymaker to be able to justify their authority in areas of distribution that may appear properly to belong to the political world.

6.17 The role of the Financial Policy Committee and political legitimacy

An institution such as the Bank of England does not exist in a vacuum. It is shaped, and in turn, shapes the political, economic and social environment in which it exists. The political legitimacy of the FPC is more difficult to evaluate. It is likely to be perceived as an obscure committee and its claims to political legitimacy are fragile being based on adherence to formal processes and on a limited level of accountability to a Parliamentary select committee. However, its actions have a very direct effect on the lives of individual citizens. The key issue is that the people that are adversely affected by, for example, the imposition of LTV and DTI restrictions are readily identifiable while the broader group who may be protected by these measures from harm arising from financial instability are not. Moreover, the causation links between the risks of a systemic failure and the actions of the committee may be seen as remote and unclear.

Moreover, the central issue is that macroprudential policy is “fundamentally a politico-economic concept”.¹⁰¹ There is a very close relationship between the economic regulatory policies embedded within the macroprudential framework and the effect on societal objectives. Consequently, as mentioned earlier, macroprudential policies have, by their very nature, “redistributive consequences” and thus, “cannot rely on a firm foundation of

⁹⁹ Giandomenico Majone, ‘Regulatory legitimacy’ in Giandomenico Majone (ed), *Regulating Europe*, (Routledge, London, 1996) 284-301, 295

¹⁰⁰ Cass Sunstein, *After the rights revolution*, (Harvard University Press, Cambridge, Massachusetts, 1990), 228

¹⁰¹ Anthony Ogus, *Regulation: legal form and economic theory*, (Clarendon Press, Oxford, 1994), 1

legitimacy”.¹⁰² Indeed, “the question of legitimacy, in spoken or unspoken form, haunts much of the debate”.¹⁰³

Governments will seek blame avoidance and this has been expressed as a major reason for the creation of non-governmental agencies to devise and execute executive policies.¹⁰⁴ The legislature “is always willing to deal rhetorically with problems requiring regulation...but real decisions...will undoubtedly raise the ire of powerful pressure groups on one side or the other that are affected by government regulation”.¹⁰⁵ Consequently, setting up an independent policymaking agency is a better method of addressing these issues at the risk that these agencies may become political forces in their own right with their own constituencies and influence. The FPC, as part of the Bank of England has an agency role. It may need to take politically unpopular decisions so placing it at least one remove from central government may have the effect of ensuring that it acts as a lightning rod by diverting popular anger away from politicians.¹⁰⁶

Moreover, there were institutional factors leading to the delegation of macroprudential policy to the Bank of England. It would have taken some time to have created a brand-new macroprudential policymaker while the Bank had the infrastructure in place to undertake the role. Moreover, placing responsibility for macroprudential policy elsewhere is likely to have resulted in a lack of coordination with the Bank of England’s macroeconomic functions ensuring friction between the Bank and the neophyte organisation. Finally, in this area, the Bank of England already had an international presence and standing with bodies such as the Financial Stability Board and Bank of International Settlements. This is an important aspect bearing in mind the former’s leading position in determining global macroprudential strategy.

¹⁰² Supra, note 99, (Majone), 295 and 299

¹⁰³ Tony Prosser, *The regulatory enterprise: government, regulation and legitimacy*, (Oxford University Press, Oxford, 2010), 4

¹⁰⁴ Kent Weaver, ‘The politics of blame avoidance’, (1986) *Journal of Public Policy*, 6 (4), 371-398, 391

¹⁰⁵ Peter Woll, *American bureaucracy*, (2nd ed, W.W. Norton, New York, 1977), 10-13

¹⁰⁶ Morris Fiorina, ‘Legislative choice of regulatory forms: legal process or administrative process’, (1982) *Public Choice*, 39(1), 33-66, 47

There are also political symbolic reasons for locating the FPC within the Bank. It provides an element of symbolism in that an institution with authority, fixed with clear responsibility has ownership and accountability for macroprudential policy.¹⁰⁷ In addition, it acts as a "signal" both internationally and domestically, following the financial crisis, that the important role of preserving financial stability has been given to a recognised authoritative body. This allows the FPC to work within the shadow of the Bank's own "mystic" and provides immediate political legitimacy to a new organisation.

The technical expertise of the Bank of England is another significant reason for allocating it macroprudential policymaking powers. The relationship between the creation of a technocracy and political legitimacy is considered next.

6.18 Technical expertise and political legitimacy

As mentioned earlier it may be possible to found political legitimacy on technocratic power operated by a "technocracy" of experts.¹⁰⁸ Moreover, there is a belief that this provides a "naïve notion of escape from politics and substitution of the voice of the expert for the voice of the people."¹⁰⁹ Reliance on "expertness" may be "incompatible with the democratic political process."¹¹⁰ In addition, the UK has traditionally had an ambivalent perspective on technical expertise with a view that "experts should be on tap but not on top".¹¹¹ It is this claim to political legitimacy by "rule of the knowers" or "epistocracy" that is considered in the next section.¹¹²

¹⁰⁷ Domenico Lombardi and Manuela Moschella, 'The symbolic politics of delegation: macroprudential policy and independent regulatory authorities', (2016) *New Political Economy*, 7-8

¹⁰⁸ For an example of the "technocratic ethos" see Lamoma Rogers 'A new approach to macroprudential policy for New Zealand', (September 2013) *Reserve Bank of New Zealand Bulletin*, Vol. 76, No. 3, 12-22, 16, which discusses macroprudential LTV limits in purely technical terms with no mention of socio-political implications.

¹⁰⁹ Marver Bernstein, *Regulating business by independent commission*, (Princeton University Press, Princeton, 1955), 493

¹¹⁰ *Ibid*, (Bernstein), 493

¹¹¹ Randolph Churchill, *Twenty-one years*, (Weidenfeld & Nicolson, London, 1965), 127 quoting his father Winston Churchill. It is a phrase I often heard during my time working in the Civil Service

¹¹² David Copp, 'Reasonable acceptability and democratic legitimacy: Estlund's qualified acceptability requirement', (January 2011), *Ethics*, Vol. 121, No. 2. 239-269, 241. David Estlund, *Democratic authority: a philosophical framework*, (Princeton University Press, Princeton, 2009), 7, develops Plato's rule by an "epistocracy" and whether it could be viewed as political legitimate

6.19 “Rule” by technicians and the Promethean struggle

One possible view is to see the FPC as a group of expert technicians who employ their independence and expertise for the common good. Haldane, and others, have described the FPC as “technocratic”.¹¹³ This suggests an omniscient macroprudential priesthood, akin to Die Zauberflötes’ Sarastro, “der göttliche Weise” (“the divinely inspired wise man”) and Haldane poses the rhetorical question if only “there were a benign enlightened regulatory planner, able to redirect competitive forces, this could potentially avert future tragedies of the financial commons. Fortunately there is”.¹¹⁴ However, as Veblen warned, “popular sentiment ...will not tolerate the assumption of responsibility by the technicians, who are in popular apprehension conceived to be a somewhat fantastic brotherhood of over-specialised cranks, not to be trusted.”¹¹⁵

Baker saw the rise of macroprudential policy as some form of promethean struggle between central banker technocrats and the forces of bankers and politicians with the final “macroprudential ideational shift” resulting from “an ‘insiders coup d’etat’, which displaced the prior efficient markets orthodox.”¹¹⁶ Similarly, Tucker has described the Bank of England’s move towards macroprudential policy as a “Gestalt flip to thinking of markets as inefficient, riddled with preferred habitats, imperfect arbitrage, regulatory arbitrage, herding, and inhabited by agents with less than idealised rationality.”¹¹⁷ However, this reasoned state of mind may be challenged during a crisis. Baker believes that after a period of “crisis politics when prior orthodoxies were overturned ... a more normal phase of conventional interest-based politics and contests between regulators and regulated can be expected to emerge”.¹¹⁸ Looking beyond this revolutionary change of view Baker believes

¹¹³ Andrew Haldane, ‘Central bank psychology’, speech at the ‘Leadership: stress and hubris conference’, hosted by the Royal Society of Medicine, London, 17th November 2014, 8

¹¹⁴ Andrew Haldane, ‘Financial arms races’, speech at the Institute for New Economic Thinking, Berlin, 14th April 2012, 10

¹¹⁵ Thorstein Veblen, *The engineers and the price system*, (published 1921, Viking Press, New York, 1954), 150-151

¹¹⁶ Andrew Baker, ‘The new political economy of the macroprudential ideational shift’, (2013) *New Political Economy*, 18 (1), 112–139, 127

¹¹⁷ Paul Tucker, remarks at Clare Distinguished Lecture in Economics, Cambridge Friday on 18th February 2011 discussing Lord Turner’s Lecture, ‘Reforming finance: are we being radical enough?’, 3-4

¹¹⁸ Supra, note 116, (Baker, ‘New political economy’), 132

that politicians, acting on behalf of the bankers, will try to restrain the Jacobins within the Bank of England.¹¹⁹ The zeitgeist will return to a Humean “higher-rationality”.

Baker describes a paradox in that “efforts to depoliticise macroprudential policy by allocating power and responsibility to unelected central banks, whose claims to authority are based on technical expertise, actually runs the risk of not only politicising macroprudential policy, but also politicising central banks themselves. In other words, depoliticisation begets politicisation.”¹²⁰

Moreover, technocrats in this role are likely to “become convinced of the correctness of their own prescriptions (and so grow over-confident) and can become divorced from popular sentiments”, therefore to avoid this trap technocratic regulators must carefully monitor their actions against the changing “wider public moods and concerns”.¹²¹ This is echoed by Tucker who believes that macroprudential policy decisions which have a direct distribution effect on individual citizens should be left with elected politicians.¹²² However, all central bank policies, whether these relate to monetary or macroprudential ends, are likely to have economic redistribution effects. Much depends on how obvious are their effects and how best the Bank employs the levers of legitimacy.

In view of concerns about the political legitimacy of its actions, the FPC has been inclined to set its policymaking within boundaries it believes are acceptable to the general will. The latter may not always be apparent and may change depending on the political, social and economic context. Establishing this boundary is considered next.

¹¹⁹ Andrew Baker, ‘The gradual transformation? The incremental dynamics of macroprudential regulation’, (2013) *Regulation & Governance*, 7, 417-434, 429

¹²⁰ Andrew Baker, ‘The bankers’ paradox: the political economy of macroprudential regulation’, (April 2015), LSE Systemic Risk Centre Discussion Paper No. 37, 26-27

¹²¹ Andrew Baker and Wesley Widmaier, ‘The institutionalist roots of macroprudential ideas: Veblen and Galbraith on regulation, policy success and overconfidence’, (2014), *New Political Economy*, Vol 19, No.4 487-506, 502-503

¹²² Paul Tucker, ‘The design and governance of financial stability regimes: a common-resource problem that challenges technical know-how, democratic accountability and international coordination’, (September 2016) *Centre for International Governance Innovation*, Vol. 3, 53-54

6.20 The politics of political legitimacy and macroprudential policy: a "Pufferstaat" boundary

For the most part the actions of a policymaking institution are accepted and not challenged on grounds of legitimacy. Indeed, as mentioned earlier, institutions such as the Bank of England have a certain level of protection against attacks on its legitimacy enhanced by its tradition and symbolism which put it beyond the "ordinary". In many ways the Bank of England is preserved by an element of Gurvitchian "magic".¹²³ However, at some point that legitimacy may be eroded and it is then that the soundness of its foundations become important.¹²⁴

The Bank of England is conscious that a reputation built-up over centuries may be squandered and, consequently, the Bank may be reluctant to employ macroprudential policies which may call into question its legitimacy.¹²⁵ As a result, its "scope for strategic action may be bounded" by what may be described as a "legitimacy boundary line".¹²⁶ This may be a "region" rather than a bright-line. Moreover, the extent of this area may change over time and depend on political, social and economic circumstances.

6.21 The legitimacy boundary

The boundary may be at the point at which macroprudential policy is directed at the individual. For example, Mervyn King described his experience in 2005 in his response to the Treasury Select Committee in 2009: "Let me explain the nature of the problem. I did speak about house prices. I gave a speech in 2005 which had quite a big impact; it was all over the front pages of the usual tabloid press. I got a lot of letters saying 'How dare you talk about house prices!'...There were a lot of comments that I should not be intervening and making comments about house prices."¹²⁷

¹²³ "Mystic experience penetrates all archaic social institutions", George Gurvitch, *Magic and law*, (1942) *Social Research*, 9.1, 104-121, 104

¹²⁴ Rodney Barker, *Political legitimacy and the state*, (Clarendon Press, Oxford, 1990), 161

¹²⁵ Financial Times, 5th April 2012, '*Bank avoids role in limiting mortgages*' quoting Tucker that "it is for the government to decide on borrowing caps", highlighting "unease among unelected technocrats at the BoE"

¹²⁶ Julia Black, 'Constructing and contesting legitimacy and accountability in polycentric regulatory regimes', (2008) *Regulation and Governance*, Vol. 2, Issue 2, 137-164, 162

¹²⁷ Mervyn King, answer to question 2354 on 26th February 2009 before the Treasury Select Committee, House of Commons Treasury Committee, *Banking crisis*, Vol. I, Oral evidence, (HC 144-I [Incorporating HC 1167 i-iv, Session 2007-08]), 281

Macroprudential policy may restrict what an individual may do; not because of anything they have done wrong (they are applying for a mortgage) but because it is in the interest of society's greater good. As a consequence the economic and regulatory policy systems are "fractured" and need "a specific mechanism of structural coupling" which can communicate a link between the private contract and the public economic interest.¹²⁸ A public/private line is "blurred" and it "unsettles our understanding of where" to locate the legitimacy of this action.¹²⁹

This can be clearly seen in the response by Adair Turner before the Parliamentary Treasury Select Committee: "I have to say that I think if we were to roll back and the FSA had come out in 2004 and had started aggressively challenging the mortgage banks to cut back on lending, I suspect that the predominant reaction of many people, including perhaps many people in this House, would have been to tell us that we should not be holding back the extension of mortgage credit to ordinary people; that we were preventing the democratisation of home ownership....we would have been pushed back politically if we had."¹³⁰ As the Governor of the Bank of England at that time said to the same Committee, "Westminster and the Government would have been lobbied; it would have been a pretty lonely job being a regulator."¹³¹ It is likely that macroprudential policies may infringe the political legitimacy boundary which directly limited the aspiration of those who wish for their own home. The extent to which it is considered acceptable to intervene in this area is considered next.

6.22 The aspiration of home ownership: acceptable and unacceptable interference in public policy

As discussed in earlier chapters housing is an emotional as well as political subject which may merit public policy interference in what is perceived to be a free market. Moreover,

¹²⁸ Supra note 97, (Luhmann, 'Operational closure'), 1435. See also Gunther Teubner, *Law as an autopoietic system*, (Blackwell, Oxford, 1993), 61-62

¹²⁹ Julia Black, 'Critical reflections on regulation', (2002) 27, *Australian Journal of Legal Philosophy*, 4 and 35,

¹³⁰ Adair Turner, answer to Question 2168 on 25th February 2009 before the Treasury Select Committee, House of Commons Treasury Committee, *Banking crisis*, Vol. I, Oral evidence, (HC 144-I [Incorporating HC 1167 i-iv, Session 2007-08]), 281

¹³¹ Ibid, Mervyn King, answer to Question 2354 on 26th February 2009

housing may have, in a Durkheimian sense, a social cohesion role.¹³² As already noted access to a home of ones' own is central, at least, to modern society and the aspiration to this goal provides a sense of hope for the future. In a Hegelian sense it is recognised as a source of individual freedom.¹³³ These are all important factors in a society's concept of social solidarity. Consequentially, as mentioned above, Habermas held that it is possible to determine a "boundary" between what is acceptable and unacceptable state interference when, for instance, there is an overwhelming desire by consumers for individual ownership of an object.¹³⁴

For example, the aspiration for home ownership in the UK could be described as a cultural tradition, albeit a relatively recent one that only started to develop after the First World War as the soldiers returned. It was seen as so important that the boundary governing state interference in the market was breached with the Housing and Town Planning Act 1919, ("the Addison Act") and is evident in the debate introducing the Second Reading of this Bill. "These men who left our shores as youths return as grown-up men. In large numbers they are seeking independent homes. We cannot offer these men hovels. We want them to have the homes which they desire."¹³⁵ The MP then moved on from demobilised soldiers to the need for homes for miners "if he [the Housing Minister] will enable any miner who wants it to have a suitable home, a home in the real British sense, a home which is really the Englishman's castle, a home reflecting the taste of the occupants of the home, as every home should do... We ask him to appeal not to cupidity but to imagination. We ask him to abandon the gospel of sops...I appeal to him to believe that the virtues of self-respect and independence are not the privilege of a class, but are the common and great inheritance of a great people." ¹³⁶

¹³² Steven Lukes and Andrew Scull, *Durkheim and the law*, (Martin Robertson, Oxford, 1983), 5-8. Durkheim saw no issue with "frustrated aspiration" provided the individual was still bound to society by wider ties and beliefs, (Emile Durkheim, *The division of labour in society*, (published 1893, Macmillan, London, 1984), 315

¹³³ Colin Tyler, 'The liberal Hegelianism of Edward Caird', (2010) *International Journal of Social Economics*, Vol. 37, Issue 11, 852 - 866, 861

¹³⁴ Supra, note 68, (Habermas, *Legitimation crisis*), 30

¹³⁵ James Kidd MP for Linlithgowshire, House of Commons debate on the Housing Bill, (7th April 1919) Hansard Archive, Vol 114, 1713-1820, 1754

¹³⁶ Ibid, Kidd MP, who was a lawyer and a Coalition Unionist MP serving in Lloyd George's government. He fought twice for his seat against Manny Shinwell. In his autobiography the latter described Kidd as "an exceptionally able man", Manny Shinwell, *Leading with the left*, (Cassell, London, 1981), 69

By way of context this legislation, which introduced housing regulation and state investment in house building, was introduced following the first UK general election with almost a modern suffrage with women having the vote for the first time, albeit only for those aged thirty or older, and against a background of revolution across much of Europe and Russia, turmoil in Ireland and global economic dislocation. It produced the first governmental large-scale housing construction programme and established good quality housing as a right and the legislation increased taxation to pay for house building subsidies.¹³⁷ Lloyd George is reported to have said that even if this cost of £100 million “what was that compared with the stability of the State”.¹³⁸ This underlines that economic and political crises may produce a shift in the boundary between public policy regulation and the unregulated market, “not only into the economic system but also into the socio-cultural system”.¹³⁹

The next section considers how the concepts of political legitimacy may be applied to the macroprudential environment.

6.23 Applying the concept of “political legitimacy” to the FPC

The political legitimacy of an institution or action is not fixed in time, once and for all. Political legitimacy inhabits a spectrum containing degrees of acceptance which fluctuate depending on circumstances and events. It is complicated by the role of intermediation by, for example, the media and lobbying groups. These issues present the FPC with a number of policy problems and options. These could include a form of “self-denying ordinance” in which the committee limits its actions to the relatively obtuse areas of counter-cyclical buffers etc which tend to attract less intermediation attention. However, if the FPC employs high-profile macroprudential tools such as LTV and DTI limits it will have to engage in the political debate and be able to explain its actions. This would mean applying a new perspective. This may be culturally difficult since “decision-makers have their own frames of reference, their own world views...the very topics under discussion may themselves

¹³⁷ David Mullins and Alan Murie, *Housing policy in the UK*, (Palgrave Macmillan, Basingstoke, 2006), 22. See also Mark Swenarton, *Homes for heroes: the politics and architecture of early state housing in Britain*, (Heinemann Educational, London, 1981), 78-79

¹³⁸ Brian Lund, *Understanding housing policy*, (2nd ed, Policy Press, University of Bristol, Bristol, 2011), 49

¹³⁹ Supra, note 68, (Habermas, *Legitimation crisis*), 47

challenge their own perceptions and frames of reference. Indeed, it may be ...so bound up in its own rationality that it is incapable of seeing beyond it.”¹⁴⁰

6.24 Possible options

It is clear from interviewing senior Bank of England staff and other policymakers that the Bank is aware of these concerns. As part of a set of options to help improve the democratic accountability of the Bank of England one suggestion has been that while the Chancellor of the Exchequer continues to appoint the chairman of the Bank, some of the other senior appointments are made directly by Parliament.¹⁴¹ Another option may be to attempt to “borrow” Parliamentary legitimisation by passing the measures through some form of Statutory Instrument process. However, HM Treasury may be reluctant to support such measures for the converse reasons that it exposes politicians to criticism and takes them into technical areas beyond their expertise and, moreover, it would negate a key reason for delegating responsibility for taking unpopular actions to an independent Bank of England. A former Treasury minister has suggested that there should be a government chaired “systemic risk oversight body...responsible for identifying and prioritizing systemic risk and making (non-binding) recommendations” with the central bank holding “operational independence” for macroprudential policy making.¹⁴² Finally, there is a tactical option under which the FPC avoids raising difficult issues and only employs macroprudential policies with a level of “low visibility” and does so in a manner which is a “conflict-minimize[r]”.¹⁴³ Nevertheless, part of an institution’s legitimacy is based on influencing opinions. How this may be approached is considered next.

¹⁴⁰ Julia Black, ‘Proceduralization of regulation’, (2000) 20 Oxford Journal of Legal Studies, 597-614, 599

¹⁴¹ Terence Daintith, ‘Between domestic democracy and an alien rule of law? Some thoughts on the ‘independence’ of the Bank of England’, in Mads Andenas and others (eds), *European economic and monetary union: the institutional framework*, (Kluwer Law International, London, 1997), 357-372, 370-371

¹⁴² Ed Balls, James Howat and Anna Stansbury, ‘Central bank independence revisited: after the financial crisis, what should a model central bank look like’, (2016) Mossavar-Rahman Centre Working Paper Series No. 67, Harvard Kennedy School, 48-49. This is a variation of the proposal to segregate the “diagnosis” of a threat to financial stability from the application of remedial measures, (Goodhart, ‘The macroprudential authority: powers, scope and accountability’), 20, supra chapt 2 n3

¹⁴³ Supra note 79, (Scharpf), 23-24

6.25 Weaving a “legitimacy narrative”

The actions of the FPC, combined with the circumstances at the time, may reinforce or undermine its legitimacy. The FPC needs continuously to weave a “legitimacy narrative”, explaining clearly what it is doing and why in terms that will resonate with the various stakeholders. In the bardic tradition it needs to publicise its struggle to ensure financial stability as if it was contesting the great mead-hall against Grendel, drawing on examples from history, its own lineage and supported by a chorus of engaged politicians and media.

6.26 A broader scope for the Financial Policy Committee

Some have stressed the need to focus on the use of macroprudential tools such as LTV and LTI limits and a “greater control of non-banks” lenders.¹⁴⁴ However, this thesis goes further and suggests that, in addition, to attempting to use macroprudential policy to suppress the demand for credit the FPC should consider what steps may be taken to increase the supply of housing. Action in this area will, of necessity, be long-term and involve a range of bodies responsible for housing policy. If undertaken on a large enough scale over a sufficient period of time such a policy would increase housing supply substantially, reduce the price of both new housing and the existing stock and help to meet demand. Borrowers would, consequently, not need to borrow as much to acquire a less scarce asset.

The FPC has expressed its view that “the persistent gap between the supply of homes and the natural growth in demand was the underlying driver of the rate of UK house price inflation.”¹⁴⁵ Nevertheless, the FPC have not given much prominence to this view nor taken a more active stance.¹⁴⁶ However, activity by the FPC in this area would trespass on the fiscal preserve of politicians and the nuanced decisions on the allocation of scarce resources. Nevertheless, there is probably scope for the FPC to review the data on the supply side and to publish its thoughts both on the short and longer term prospects on

¹⁴⁴ Tony Dolphin and Matt Griffith, ‘Forever blowing bubbles? Housing’s role in the UK economy’, (May 2011), Institute for Public Policy Research Report, 46-47

¹⁴⁵ FPC meeting minutes of 20th September 2016, published on 3rd October 2016, 5

¹⁴⁶ Martin Čihák and others, ‘Financial stability reports: what are they good for?’, (2012) IMF Working Paper WP/12/1, 16, an international survey of such reports indicates that market developments are limited to a descriptions rather than any analysis or discussion

housing policy and its implementations. At the very least, the FPC could give emphasis to this work and provide authoritative information and views for Parliamentary select committees to consider, question and influence and for Parliament to debate.¹⁴⁷

6.27 Conclusion

The foundations of political legitimacy rest on a democratic consensus. It requires a certain level of trust and understanding in democratic government and its institutions reinforced by democratic accountability and transparency. In addition to laws setting out legal processes establishing and maintaining this accountability, there needs to be a set of understandings and conventions governing the exercise of macroprudential policymaking and which set boundaries governing the use of such powers. These will change over time and vary depending on circumstances.

Sustaining political legitimacy may not be easy since, in some circumstances, it may be fragile as power flows to and from institutions. It does not exist in a vacuum but will depend on socio-economic and political factors. It is also subject to social “sentiment”. This is particularly true in many areas where strong aspirations and expectations operate which influence the acceptance of institutional and policymaking political legitimacy. This is especially relevant to the potential use of LTV and DTI macroprudential tools by the FPC.

This chapter does not dismiss the possible employment of such instruments but it argues that a different approach is necessary in view of the concerns surrounding their political legitimacy. Moreover, this thesis seeks to provide other options including developing the application of conduct of business regulation both to protect borrowers and individual lenders but also for wider macroprudential purposes. These aspects have been covered in earlier chapters.

In addition, this chapter highlights the need for the FPC to address the aspirational desire for homeownership and the need for the committee to take a broader view of its role in supporting the need for a significant increase in housing supply. The FPC also needs to develop a longer-term approach to explaining its role and operations to a general audience. The search for political legitimacy by the FPC cannot be based solely on

¹⁴⁷ For example, the Netherlands Central Bank published the conclusions of a meeting of its Financial Stability Committee of 12th May 2012 in which it commented on the failure to increase the supply of homes for rent in relation to macroprudential policy

rational, cold argument. It needs to engage the hearts as well as the brain and be based on a narrative with emotional appeal.

CHAPTER 7

US Federal intervention in the housing market and possible lessons from the Veterans Administration

“No greater contribution could be made to the stability of the Nation and the advancement of its ideals, than to make it a nation of homeownership families”¹

7.1 The Homeownership Aspiration

Both the US and UK share similar views on the need for home ownership but each has approached trying to achieve this objectives very differently. This chapter sets out the common themes and significant differences and highlights what the UK could learn from what appear to be the effects of sound conduct of business measures at the Veterans Administration (VA) in performing a macroprudential task.

How a state views home ownership may say something about its ideology and is emblematic of what countries consider important. For example, in the US the government view is that housing is an “economic good”, a “human right” and a “bulwark of democracy”, tracing this back to the Jeffersonian “yeoman farmer”.² Homeownership forms part of the “American Dream”.³ The ideological roots of homeownership in the US are deep but “first gain prominence as a moral issue” in the 1920s as a bulwark against “socialism and communism”.⁴ However, the modern Federal support for homeownership dates from the

¹ President Calvin Coolidge, quoted in Kenneth Jackson, *Crabgrass frontier: the suburbanization of the United States*, (Oxford University Press, Oxford, 1985), 362

² David Reiss, ‘Message in a mortgage: what Dodd-Frank’s “Qualified Mortgage” tells us about ourselves’, (2012), Brooklyn Law School Legal Studies Research Paper 264, 2

³ Jim Cullen, *The American Dream: a short history of an idea that shaped a nation*, (Oxford University Press, Oxford, 2004), 133

⁴ Lawrence Vale, ‘The ideological origins of affordable homeownership efforts’ in William Rohe and Harry Watson (eds), *Chasing the American Dream*, (Cornell University Press, Ithaca, New York, 2007), 19-20

Great Depression with the creation of the Federal Housing Administration and subsequent legislation.⁵

The US is unique among western nations in the level of government intervention in the housing market. Much of this is focused on the residential mortgage market. Since the 1930s, in a series of actions, the Federal government has both encouraged and deterred residential mortgage lending.⁶ These interventions have had both economic and social-engineering purposes, and consequences, and both aspects can be seen closely intertwined in what can be described as the three main waves of Federal intercession.

The Federal government first initiated steps in 1933 to save the US from financial collapse and to preserve social cohesion. However, at the same time, the actions taken resisted social change and maintained, and may even have strengthened, racial segregation.⁷ A second, and even more intense, wave of Federal intervention in the housing market started in 1944 and continues both through legislation and the operations of the Government Sponsored Enterprises (GSEs). This established the “American Dream” of homeownership and turned it into a reality for millions of service men and women returning from World War II and the Korean War. In a few decades it created a large middle class and extended city suburbs across the country.

A third intervention wave, started in the late 1960s and strengthened in the late 1990s and early 2000s. It sought to continue the process of economic redistribution to US minorities to help ensure social fairness and cohesion. Some, as described later in this section, have claimed that it was an intervention too far and have blamed it, in whole or part, for the recent financial crisis. However, others have defended the Federal role in this area and instead criticised loose monetary policy and the actions, ethics and mis-aligned innovations of lenders. The arguments on both sides have become politically partisan.

⁵ The National Housing Act 1934, Public Law 84-345, 48 Stat. 847. The Federal National Mortgage Association (“Fannie Mae”) was established in 1938 to fund lenders providing mortgages under an amendment to the National Housing Act 1934 (Ch.13, §1, 52, Stat. 8). This created a market based solution to ensuring a continuous supply of mortgages even in times of economic contraction

⁶ Douglas Elliott, Greg Feldberg, and Andreas Lehnert, ‘The history of cyclical macroprudential policy in the United States’, (2013) Office of Financial Research Working Paper No. 8, Department of the Treasury, Washington DC, 1-74

⁷ For example, Federal Housing Administration, *Underwriting Manual*, ‘Rating of location: protection from adverse influences, Part II’, (1936) discussed later

This section looks at aspects of these three waves of Federal intervention in the US housing market. It briefly sets out the history of these actions and highlights both the economic and, especially, the social purposes behind each phase. Each of these steps were both revolutionary for its time and necessary, but each contained serious flaws which fell to the next generation, and next intervention wave, to attempt to correct. It could be said that the process continues but reform appears to have been halted by the pressure of various powerful interest groups.

However, hope of positive change exists in what some might view as an unlikely quarter. This section highlights the approach taken by the US Veterans Administration (“VA”), guardians of the “G.I. Bill of Rights”. The VA were unusual among all the Government Sponsored Enterprises in the US in operating an approach to mortgage lending which is both generous, requiring no deposit by the borrowers, and by applying strict loan affordability criteria and an independent property valuation regime. Consequently, the VA, and those that it helped, avoided the problems of the financial crisis and may help set a model approach for both the US and other countries seeking to maintain the aspiration to have a place called home.

7.2 A brief history of US Federal intervention

Although a number of State chartered banks could lend against real property until 1913 US national banks were not permitted to make loans secured on land.⁸ It was the Federal Reserve Act 1913 which first allowed this in very limited circumstances, for farm land.⁹ Subsequent legislation in 1916 and 1927 extended this to residential real estate but subject to very tight limits including a maximum five year loan term.¹⁰

Both Federal and State policies contributed to a number of residential property bubbles. For example, there was a residential property boom in the 1920s which reached its zenith in 1926 followed by similar “irrational exuberance” in commercial property and equity

⁸ Carl Behrens, ‘Legal framework of urban mortgage lending by commercial banks’ in Carl Behrens (ed), *Commercial bank activities in urban mortgage financing*, (National Bureau of Economic Research, 1952),16

⁹ S24, Public Law 63-43 63d Congress H.R. 7837

¹⁰ Supra note 8, (Behrens) 17-18

stocks leading to the Great Crash.¹¹ However, the 1920s property collapse had only been based on limited amounts of credit. Banks had been relatively cautious in their levels of home mortgage lending and debt to asset ratios never rose above 25% compared to over 60% in 2006.¹²

Prior to the Great Depression, housing mortgages were issued with very short maturities and subject to variable rate interest with low LTV ratios.¹³ Every five years or so the borrower refinanced the mortgage. The banking crisis in 1932 and 1933 prevented this happening and properties were increasingly foreclosed and sold onto a sharply falling market as banks struggled to maintain their solvency and, more importantly, their liquidity as depositors rushed to withdraw their money.¹⁴ In 1933 the new administration sought to alleviate the panic by employing a number of measures including the creation of Federal deposit insurance and the establishment of the Home Owners Loan Corporation (HOLC). The aim was to halt the epidemic of home foreclosures and to inject liquidity into the housing market to get lending going and housing built, and hence, employment restarted.

Using highly liquid government backed bonds the HOLC bought over a million problem mortgages from the banks and other financial institutions allowing the borrower to remain in their home and it converted these short loans into long term fixed-rate repayment mortgages.¹⁵ The latter carried a lower rate of interest and coupled with the longer period to maturity made the loan more affordable and reduced the probability of default. Nevertheless, the HOLC still ended up foreclosing on nearly 20 per cent of the refinanced loans by 1940.¹⁶

¹¹ Gregg Turner, *The Florida land boom of the 1920s*, (McFarland, Jefferson, North Carolina, 2015), 165. However, there were extensive bank failures in both Florida and Georgia in the late 1920s due to fraud and commercial lending linked to the residential property boom, Raymond Vickers, *Panic in paradise: Florida's banking crash of 1926*, (The University of Alabama, Tuscaloosa, 1994)

¹² Alexander Field, 'The interwar housing cycle in the light of 2001-2012: a comparative historical perspectives' in Eugene White, Kenneth Snowden and Price Fishback (eds), *Housing and mortgage markets in historical perspective*, (National Bureau of Economic Research, University of Chicago Press, Chicago, 2014), 39-80, 72-73

¹³ Todd Zywicki, chapt 5, n98, 3

¹⁴ Richard Green and Susan Wachter, 'The American mortgage in historical and international context', (2005) *Journal of Economic Perspectives*, Vol. 19, No. 4, 93-114, 95

¹⁵ *Ibid*, (Green and Wachter), 95

¹⁶ Price Fishback and John Wallis, 'What was new about the New Deal?', in Nicholas Crafts and Peter Fearon (eds), *The Great Depression of the 1930s: lessons for today*, (Oxford University Press, Oxford, 2013), 318

The New Deal led to the creation of a number of other Federal housing support agencies including the Federal Savings and Loan Insurance Corporation (FSLIC) created to guarantee deposits at savings and loans organisations. The Federal Housing Administration (FHA) was established to provide government insurance to support the sale of mortgages into the general financial market and thus to generate more liquidity in the housing markets. In 1938 the emergency HOLC was replaced by Federal National Mortgage Association (“Fannie Mae”). The Federal Home Loan Mortgage Corporation (“Freddie Mac”) was created in 1970 to provide some competition in this secondary market.

These Federal bodies were conceived in a period which admired soviet central planning.¹⁷ This needs to be seen in the context of social and financial collapse in the 1930s, amid calls to nationalise the banking system and the deployment of Federal and State troops across the country. Initially, the steps taken in this area in the 1930s did not distinguish between actions needed to preserve the economy and those required to maintain social cohesion. In time the latter objective grew in priority with housing and its finance used to effect socio-political objectives including support for veterans, farmers and minority ethnic groups.

The 1960s saw Federal intervention in the housing market focus on low-income housing projects. However, the on-budget cost of these projects and “the association of many of these with violence and drug use” increasingly turned Federal intervention towards using GSEs to finance homeownership.¹⁸ In addition, the Federal government continued to provide direct support for residential housing through tax subsidies for homeowners, including permitting the deductibility of mortgages interest and the exemption of homes from capital gains taxation.¹⁹

¹⁷ Many New Deal policies were influenced by Upton Sinclair and his “End Poverty In California” (EPIC) programme which envisioned a state-wide disability and pensions scheme and the state ownership of the means of production, including land, to provide work and the establishment of workers cooperatives, George Rising, ‘An EPIC endeavor: Upton Sinclair's 1934 California Gubernatorial Campaign’, (1997) *Southern California Quarterly*, Vol. 79, No.1, 101-124, 111. Harry Hopkins, who went onto run many of the major New Deal programmes including the Federal Emergency Relief Administration, was supportive of the EPIC programme, *Ibid*, 117.

¹⁸ Nolan McCarty, Keith Poole and Howard Rosenthal, *Political bubbles: financial crises and the failure of American democracy*, (Princeton University Press, New Jersey, 2013), 128

¹⁹ Michael Carliner, ‘Development of Federal homeownership “policy”, (January 1998) *Housing Policy Debate*, Vol. 9(2), 299-321, 300

7.3 Supporting minority group

As mentioned in chapter 5 there is cross-party support in the US for public policy measures aimed at ensuring a ready supply of mortgage lending. In part, this is an ideological concept based on the home as part of the “American Dream” coupled with sociological evidence that home ownership appears to support improvements in householder civic engagement and improved outcomes for children. Homeownership also supports the housing development and construction industry, those marketing and selling residential property and all those involved in maintaining properties and related services. Most importantly, in the US context, the aspiration of owning a home of one’s own allowed ethnic minorities to play their part in society.

Racial segregation runs very deep in the US and a mixture of price barriers and restrictive covenants preventing the sale of residential properties to “non-caucasian whites” was wide-spread until the latter part of the twentieth century.²⁰ For example, all the extensive housing developments during the 1920s Florida property boom contained these restrictions.²¹ In 1926, the US Supreme Court upheld these covenants.²² Indeed, “in some cities restrictive covenants were estimated to cover as much as 80% of residential property.”²³ In 1921 the “Chicago Real Estate Board threatened to expel any member who sold a property” in an all-white area to a non-white.²⁴

From the start, the Federal housing agencies supported and developed segregation. For example, the Federal Housing Administration’s 1936 “Underwriting Manual” said that Federal support would be restricted in order to ensure that properties “continued to be occupied by the same social and racial groups.”²⁵ The process of Federal intervention in favour of segregation continued until the 1960s and had a significant effect on the social structure of many US cities. For example, in the late 1930s the expansion of Detroit led, in

²⁰ Supra note 1, (Jackson), 133

²¹ Supra note 11, (Turner), 143

²² *Corrigan v. Buckley*, 271 U.S. 323 (1926)

²³ Christopher Bonasta, *Knocking on the door: The Federal Government’s attempt to desegregate the suburbs*, (Princeton University Press, Princeton, 2006), 60

²⁴ Ibid, 60

²⁵ Supra note 7, (Federal Housing Administration, *Underwriting Manual*), (1936), Part II, para 233

the view of the FHA, to some white property acquisitions coming too close to black owned homes. The result was that Federal mortgage guarantees were unavailable due to their “proximity to an ‘inharmonious’ racial group.”²⁶ Prior to the 1960s Federal housing support largely went to white middle-class borrowers and, in part due to Federal policy, the white population was able to flee to the suburbs and cities such as St Louis became a “premier example of urban abandonment”.²⁷

However, the 1960s introduced significant changes in the Federal position on civil society and desegregation. As seen in chapter 5, homeownership was viewed as having a major role in this process and this view led to the Housing and Community Development Act 1974 which allowed greater flexibility in mortgage lending with the objective of increasing home ownership and community development for those formally excluded.²⁸ The chairman of the Senate Committee on Banking, Housing, and Urban Affairs claimed “that this legislation is the most significant in the field of housing legislation since the” 1930s.²⁹

The social upheavals, rioting and arson in US inner cities in 1967 lead to President Johnson, as part of his “Great Society” programme, to propose the Housing and Urban Development Act of 1968, with a goal of constructing 26 million homes over ten years, including those to “replace the shamefully substandard units of misery where more than 20 million Americans still live.”³⁰ “Homeownership is a cherished dream and achievement of most Americans. But it has always been out of reach of the nation’s low-income families. Owning a home can increase responsibility and stake out a man’s place in his community. The man who owns a home has something to be proud of and good reason to protect and preserve it. Today I propose a program to extend the benefits of homeownership to the nation’s needy families... let us go forward, as one nation in common purpose joined, to

²⁶ Supra note 1, (Jackson), 209. The HOLC commissioned a study in 1933 which developed the original “red-lined” city maps designating “hazardous” lending zones, Glenn Alschuler and Stuart Blumin, *The GI Bill: the New Deal for veterans*, (Oxford University Press, Oxford, 2009), 200

²⁷ Supra note 1, (Jackson), 285-286

²⁸ 12 U.S.C. 1706e, Public L. No. 93-383, 88 Stat. 633

²⁹ Quoted in President Gerald Ford’s, ‘*Remarks on signing the Housing and Community Development Act of 1974*’, on 22nd August 1974, The American Presidency Project website, <http://www.presidency.ucsb.edu/ws/?pid=4620>, (accessed 19th July 2017)

³⁰ Lyndon Johnson, “Special message to the Congress on urban problems: *the crisis of the cities*.” 22nd February 1968, The American Presidency Project website, <http://www.presidency.ucsb.edu/ws/?pid=29386>, (accessed 3rd July 2017)

change the face of our cities and to end the fear of those - rich and poor alike - who call them home.”³¹

7.4 Recent history and influences

Through the 1980s, 1990s and early 2000s there were a number of parallel and self-reinforcing initiatives by those supporting a homeownership socio-political agenda, legislators, lenders and financiers devising innovative financial products and those seeking to protect borrowers. During this latter period the increase in home-buying was led by first time buyers aged under 35 (15.5%) compared with a 2.7% increase by those in 45-54 year old age bracket.³² A range of legislative changes promoted lending to disadvantaged groups of citizens. These included legislation which expanded the range of products and changes in regulations (eg the Depository Institutions Deregulation and Monetary Control Act of 1980) which allowed all federally insured banks and thrifts to raise mortgage interest rates on all home loans pre-empting State usury laws. There was also the “Alternative Mortgage Transactions Parity Act (1982) (AMTPA) which allowed all “lenders to issue adjustable rate, mortgages with large end “balloon” payments and non-amortising mortgages”.³³ There was also other legislation which provided additional incentives to lend to low income group (eg the Federal Housing Enterprise Financial Safety and Soundness Act 1992 and Community Reinvestment Act 1977). It is important to understanding the context in order to better elucidate the problems and solutions. As mentioned above, some consider that this series of laws were instrumental in persuading

³¹ Ibid, (Johnson)

³² Garriga and Schlagenhauf, ‘Recent trends in homeownership’, 398, chapt 5, n10

³³ Kathleen Engel and Patricia McCoy, ‘A tale of three markets: the law and economics of predatory lending’, (2002) 80 Texas Law Review 1255, 1275

The full titles of each Act are:

The Depository Institutions Deregulation and Monetary Control Act 1980 (H.R. 4986 Pubic Law 96–221),

The Alternative Mortgage Transaction Parity Act 1982 contained within Title VIII of the Garn–St Germain Depository Institutions Act 1982 (H.R. 6267 Public Law 97-320),

The Federal Housing Enterprises Financial Safety and Soundness Act 1992, (Public Law 102-550) contained within Title XIII of the Housing and Community Development Act 1992, (H.R. 533 106, Statute 3941, 12 U.S.C § 4501),

The Community Reinvestment Act (Public Law 95-128, 91 Statute 1147, contained within Title VIII of the Housing and Community Development Act 1977 (12 U.S.C. § 2901)

lenders to extent credit to those who should not have borrowed. This issue is considered in the next section.

In 1995 President Clinton's administration issued its National Homeownership Strategy.³⁴ Nevertheless, even as late as 2003 there were still significant disparities in homeownership rates.³⁵ Consequently, in 2002 President Bush launched his "Blueprint for the American Dream".³⁶ The objective of this plan was to increase minority homeownership by 5.5 million by 2010, by providing assistance with funding and down payments and increasing the supply of affordable housing.³⁷ There can be few Federal strategies that have commanded such broad support across political parties, the financial services industry, social change campaigners and the property and construction sectors.³⁸ It is symbolic that in 2002 a Presidential Proclamation declared that the month of June would be known as "National Home Ownership Month".³⁹ The Proclamation on 4th June 2002 announcing this described "Homeownership [as] an important part of the American Dream ... a home provides ... a source of great personal pride and an important part of community stability."⁴⁰ The Proclamation extolled the benefits of homeownership as it "encourages personal responsibility and the values necessary for a strong family. Where homeownership flourishes, neighborhoods are more stable, residents more civic-minded, schools better and crime rates decline."⁴¹ The President pledged the resources of the Federal government to help people to buy their own homes and to "pursue a better quality

³⁴ The objective of this strategy was to create up to eight million new homeowners by 2000 using a range of mechanisms including expanded Federal downpayment assistance and other forms of direct funding. See Rohe and Watson, *Chasing the American Dream*, 8, *supra* note 4

³⁵ 75% of whites owned their own homes compared with 48% for black and 47% hispanic households ('State of the Nation's Housing', (2003), Harvard University Joint Centre for Housing Studies, Fig 17, 17

³⁶ A presidential announcement: *A blueprint for the American Dream: a public/private partnership to increase minority homeownership by 5.5 Million by the end of the decade*, (archive of the Department of Housing and Urban Development)

³⁷ *Ibid*, (*Blueprint*), 2

³⁸ Calomiris and Haber describe it as a "grand banking bargain" to benefit all interested parties, *Fragile by design*, 216-255, chapt 3, n13

³⁹ 'Recognizing national homeownership month and the importance of homeownership in the United States', House of Representatives, Motion 477, 110th Congress (6th November 2007)

⁴⁰ *National Homeownership Month, Presidential Proclamation*, (June 2002) White House Archive, George W. Bush, press releases

⁴¹ *Ibid* (*Homeownership Month*)

of life.”⁴² Further, the homeownership aspiration was “politically popular, in part, because it has a myriad of constituencies” including “developers, the financial services industry, planners, road-builders” etc.⁴³ This was encouraged by regulatory changes.

In 2004 in support of increased homeownership lending the Office of the Comptroller of the Currency (OCC) enacted a preemption rule preventing individual states applying laws which restricted the terms of mortgage lending, including borrower ability to repay verification.⁴⁴ This applied to all national banks supervised by the OCC. Research indicates that while controlling for other factors this resulted in an annual increase of between 11-15% in mortgage lending between national banks and those solely subject to State supervision which restricted lending to customers at risk of default.⁴⁵ These regulatory were bound-in with political views and supported by socio-economic factors encouraging homeownership.

7.5 Socio-economic evidence

A considerable amount of socio-economic academic research supports the benefits of homeownership. For example, renters appear to have much less civic engagement with only 52% of renters saying that they had voted in local elections compared with 77% of homeowners.⁴⁶ Without owning your own home achieving upward social mobility is more difficult.⁴⁷ In addition, there is evidence that a family owning its own home “predicts positive outcomes for children” with continued school attendance and reduced teenage pregnancies.⁴⁸ Although the evidence is not conclusive there do appear to be public policy

⁴² Ibid, (*Homeownership Month*)

⁴³ Anne Shlay, ‘Low-income homeownership: American dream or delusion?’, (March 2006) *Urban Studies*, Vol.43, No. 3 511-531, 512

⁴⁴ Marco Di Maggio and Amir Kermani, ‘Credit-induced boom and bust’, (2016) Harvard Business School Working Paper 17-010, 2-3. See also chapt 5 n117 on the Illinois lending pilot.

⁴⁵ Ibid, (Maggio and Kermani), 4

⁴⁶ Denise DiPasquale and Edward Glaeser, ‘Incentives and social capital: are homeowners better citizens?’, (1999), *Journal of Urban Economics* 45, No. 354-384

⁴⁷ Will Paxton and John Brynner, *The asset effect*, (The Institute for Public Policy Research, London, 2001) and developed by Alex Nunn, ‘Factors influencing social mobility’, (2007) Department for Work and Pensions Research Report No 450, 39. In essence the argument is that owning assets, not necessarily only housing, gives an individual a stake in society and promotes better citizenship

⁴⁸ Richard Green, Gary Painter and Michelle White, ‘Measuring the benefits of homeownership: effects on children redux’, (2012), Research Institute for Housing America: Special Report, 33

benefits supporting homeownership.⁴⁹ However, although causality may be difficult to determine, at the very least, homeownership is a symbol of a family's aspiration to prosper and to put down enduring roots.⁵⁰ It is important to understand the aspirational and socio-economic public policy context in order to make sense of what happened in the years leading up to the financial crisis.

The GSEs were some of the chosen instruments to effect these housing policies. Their role is considered next.

7.6 Role of GSEs and the Community Reinvestment Act 1977 in the recent financial crisis

Following on the creation of the “Great Society” in the 1970s, the socio-economic purpose of the GSEs was amended and coupled with anti-discrimination legislation. This had the effect of embedding the financial and economic structures, which originated in the 1930s, in the US mortgage and financial markets of the last decades of the twentieth and early part of the twenty-first centuries. The combination of the latter legislation with the role of the GSEs, magnified by financial innovation, has been blamed by many for the recent financial crisis. Further, the GSEs were implicated in the Savings and Loan crisis in the 1980s.⁵¹ In summary, it is claimed that the two largest GSEs, Fannie Mae and Freddie Mac, between the 1990s and 2006, motivated by hubris and politically driven socio-

⁴⁹ William Rohe, Shannon Van Zandt and George McCarthy, ‘The social benefits and costs of homeownership: a critical assessment of the research’, (October 2001) Low-Income Homeownership Working Paper Series 01.12, Harvard University Joint Centre for Housing Studies, 23. The same paper suggests that those advocating homeownership “should be careful not to oversell” it. See also William Rohe and Leslie Stewart, ‘Homeownership and neighborhood stability’, (1996) Housing Policy Debate, Fannie Mae Foundation, Vol. 7, Issue 1, 37-79, 53 and 71

⁵⁰ Julie Isaacs, Isabel Sawhill and Ron Haskins, ‘Getting ahead or losing ground: economic mobility in America’, (2008), The Brookings Institute, Washington DC, 50. See also William Rohe and Mark Lindblad, ‘Reexamining the social benefits of homeownership after the housing crisis’, (August 2013) Harvard University Joint Center for Housing Studies, 45 and Peter Rossi and Eleanor Weber, ‘The social benefits of homeownership: empirical evidence from national surveys’, (1996) Housing Policy Debate 7, No.1, 29 which show some, albeit, weak evidence of social benefit

⁵¹ George Benston and George Kaufman, ‘FDICIA after five years’, (Summer 1997) Journal of Economic Perspectives, Vol. 11, No. 3, 139-158, 140. The GSEs preference for long-term fixed rate mortgages opens the risk of interest rate mis-match with other lenders, such as the Savings and Loan associations, exposed by their short-term variable rate deposits and money market funds finance. This issue coupled with deregulation in the early 1980s is largely blamed for the Savings and Loan crisis in that decade

economic targets, relaxed their underwriting standards and financed unsustainable borrowings.⁵²

Further, additional obloquy is attached to the Community Reinvestment Act 1977 (CRA).⁵³ The CRA had little effect between its introduction in 1977 and 1992 with only some \$43 Bn lent by banks under this legislation in total during this period.⁵⁴ President Clinton said in 1999 that the CRA was “pretty well moribund until we took office...”.⁵⁵ In parallel, many banks sought to merge and national banks needed Federal Reserve Board approval to do so. CRA activist groups set up the National Community Reinvestment Coalition as an umbrella group to promote their interests. This group in turn issued a guide on how to negotiate with banks seeking merger permission.⁵⁶ Banks judged a “good citizens” by CRA activist groups were more likely to have the latter’s support for their merger plans.⁵⁷

Again the perception was that in the early 1990s, with a change in administration, there was renewed political interest in helping disadvantaged ethnic groups buy their own homes. This resulted in private sector lenders seeking political credit for meeting their CRA objectives.⁵⁸ The latter new lending objective arose in reaction to studies evidencing racial discrimination in granting mortgages coupled with a need to re-inflate the US economy

⁵² See, for example see chapt 3 n13, (Calomiris and Haber), 252-255

⁵³ 12 USC § 2901

⁵⁴ Supra chapt 3 n13, (Calomiris and Haber), 216-226

⁵⁵ Supra chapt 3 n13, (Calomiris and Haber), 217

⁵⁶ The National Community Reinvestment Coalition (NCRC) web-site, “formed in 1990 by national, regional, and local organizations to develop and harness the collective energies of community reinvestment organizations from across the country so as to increase the flow of private capital into traditionally underserved communities.” www.ncrc.org/programs-a-services-mainmenu-109/policy-and-legislation-mainmenu-110/the-community-reinvestment-act-mainmenu-80/community-reinvestment-act-q-a-a-mainmenu-159, (accessed 19th May 2017), “Monitor bank mergers, acquisitions and expansions to identify strategic opportunities to encourage banks in your local area to improve their community reinvestment records”

⁵⁷ The Financial Crisis Inquiry Report, (January 2011), The Financial Crisis Inquiry Commission, 97-98, <https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>, (accessed 10th September 2017)

⁵⁸ U.S. House of Representatives Committee on Oversight and Government Reform, chaired by Darrell Issa, “*The role of Government affordable housing policy in creating the global financial crisis of 2008*”, released July 2009 and updated May 2010), 9, House of Representatives, “Although the annual value of CRA home mortgage lending increased some 250% between 1996 and 2008, CRA lending never exceeded about 3% of total originations. While CRA cannot be directly blamed for the huge volumes of risky nonprime mortgages ... CRA continued a pattern of behavior of lowering mortgage underwriting standards”

after the recession in the early 1990s.⁵⁹ Moreover, there is an argument that regulators encouraged banks in the 1990s and 2000s to relax their credit standards to increase lending to poor areas subject to the CRA and that this piece of legislation was a major contributor to the financial crisis in the US.⁶⁰ There were also warnings of the potential effect of “anti-redlining” regulations “imposing substantial costs [of default] on financial institutions and the public” as early as 1980.⁶¹ This view has taken on a political complexion with allegations that regulation has been “captured” by the political process.⁶²

These issues were reviewed by the Congressional Financial Crisis Inquiry Commission which issued its report in 2010. However, all the Republican members of the commission dissented and one member of the commission, Peter Wallison, a fellow of the American Enterprise Institute (AEI), issued his own report.⁶³ In this document he laid the blame for the financial crisis on the CRA and support for affordable housing. This view was based on an earlier paper by Edward Pinto, another fellow of the AEI and, until the late 1980s, an executive vice president and the chief credit officer for Fannie Mae.⁶⁴ However, a number of subsequent papers have criticised both the statistics and the analysis in this latter paper.⁶⁵ Other research concludes that while it is possible that CRA compliant lending did have some effect on poor credit decisions the results were not significant and were “not a

⁵⁹ Alice Munnell and others, ‘Mortgage lending in Boston’, (1992) Working Paper No. 92-7, Federal Reserve Bank of Boston, 2, “after controlling for financial, employment, and neighborhood characteristics, black and Hispanic mortgage applicants in the Boston metropolitan area are roughly 60 percent more likely to be turned down than whites”.

⁶⁰ Rajan Raghuram stated that while “irrational exuberance played a part ...perhaps more important [factors] were the political forces distorting the markets. The tsunami of money directed by a US Congress, worried about growing income inequality, towards expanding low income housing, joined with the flood of foreign capital inflows to remove any discipline on home loans.”, *‘Bankers have been sold short by market distortions’*, (Financial Times, 2nd June 2010)

⁶¹ James Barth, Joseph Cordes and Anthony Yezer, ‘Financial institution regulations, redlining and mortgage markets’, (October 1979), The Federal Reserve Bank of Boston Conference Series on ‘The regulation of financial Institutions’, 101-143, 134

⁶² John Campbell and others, ‘The regulation of consumer financial products: an introductory essay with four case studies’, (September 2010) Harvard Kennedy School Faculty Research Working Paper, 10-040, 37

⁶³ Peter Wallison, *Dissent from the Majority Report of the Financial Crisis Inquiry Commission*, (AEI Press, Washington D.C., 2011) blames the financial crisis on US government housing policy and Edward Pinto, ‘Acorn and the housing bubble’, Wall Street Journal, 12th November 2009

⁶⁴ Edward Pinto, ‘Triggers of the financial crisis’, (2010) a memorandum to staff of the Financial Crisis Inquiry Commission

⁶⁵ For example, David Min, ‘Faulty conclusions based on shoddy foundations’, (2011), Paper for the Centre for American Progress

significant contributor to the financial crisis.”⁶⁶ One research paper looked at the period around which banks were assessed for CRA compliance in the period 1999 to 2009 and found that CRA lending rose by 5% compared with banks not assessed at the same time.⁶⁷ This is seen as evidence that the CRA influenced the quality of credit assessments since there was a 15% increase in defaults in loans made during this period.⁶⁸ However, three other sets of research found that the effect of CRA compliant lending was much smaller and that this aspect of the provision of mortgage credit had not been responsible for the financial crisis.⁶⁹ Nevertheless, there is evidence from a pilot study in Chicago that paternalistic legislation to protect sub-prime borrowers was effective and that this form of protection was only removed after litigation and protests by community activists and residents on the grounds that it was discriminatory.⁷⁰ However, as the next section indicates, the facts about the type and quality of GSE supported lending, prior to the financial crisis, are unclear and disputed.

Estimating the level of subprime business is impossible for this period because, for example, Fannie Mae only classified loans as sub-prime if they originated from a lender specialising in this sector.⁷¹ This probably understates the level of such lending. Moreover, the view that the GSEs restricted themselves to acquiring only prime mortgages is wrong, since, for example, the GSEs entered into extensive agreements with various mortgage originators to provide secured loans to low and moderate income households.⁷² This compounded the general decline in lending standards. For example, the Office of the

⁶⁶ Neil Bhutta and Daniel Ringo, ‘Assessing the Community Reinvestment Act’s role in the financial crisis’, (2015) Federal Reserve Board, FEDS Notes

⁶⁷ Sumit Agarwal and others, ‘Did the Community Reinvestment Act lead to risky lending?’, (2012) National Bureau of Economic Research, Working Paper 18609

⁶⁸ Ibid, (Agarwal), 24

⁶⁹ Neil Bhutta and Glenn Canner, ‘Did the CRA cause the mortgage market meltdown?’, (2009) Federal Reserve Bank of Minneapolis Community Dividend looked at mortgages written in 2005-6 and found that only 6% were related to CRA requirements. Further work indicated that CRA related lending held-up well and few went into default, Neil Bhutta and Glenn Canner, ‘Mortgage market conditions and borrower outcomes’, (2013) Federal Reserve Bulletin, Vol. 99. This supports the findings of Robert Avery and Kenneth Brevoort, ‘The subprime crisis: is government housing policy to blame?’, (2011) Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs Federal Reserve Board, Washington, D.C., 26-27

⁷⁰ Supra chpt 5 n117. See also supra n44, (Di Maggio and Kermani)

⁷¹ Oonagh McDonald, *Fannie Mae and Freddie Mac*, (Bloomsbury, London, 2012), 244

⁷² Ibid, 251-252. For example, in 2003 Fannie Mae agreed with Washington Mutual to finance \$85 Bn of home loans over five years to such families

Comptroller of the Currency's 2005 report found that banks continued "to ease retail [underwriting] standards primarily because of increased competition".⁷³

There are wildly different views on the extent of the subprime problem depending, largely, on individual political perspectives. For example, one version claims that by mid-2008 there were almost 27 million subprime mortgages; about 50% of the total number of mortgages (55 million).⁷⁴ "Two-thirds of these (16.8 million) were held or guaranteed by the FHA and the GSEs and by US banks (2.2 million)." ⁷⁵ Somewhere between 8-13 million of these were foreclosed. ⁷⁶ These figures are based on research by Pinto at the American Enterprise Institute and this work has been criticised by the Centre for American Progress: "Pinto's estimate that there are 26.7 million subprime and Alt-A loans outstanding (roughly half of all outstanding loans) is an enormous outlier among analysts. The nonpartisan Government Accountability Office (GAO) found that as of December 31, 2009, there were only 4.58 million outstanding subprime and Alt-A loans out of roughly 55 million total loans. In other words, Pinto's estimate of subprime and Alt-A exposure throughout the mortgage system is more than five times greater than the GAO's estimate."⁷⁷

However, it is clear that to reform the GSEs both prior and subsequent to the financial crisis has proved very difficult. The combination of social interest groups, lenders, mortgage brokers, construction firms and the GSEs themselves have thwarted change. It is reported that between "1998 and 2008, Fannie Mae and Freddie Mac spent over \$176 million on lobbyists. They paid lobbyists to influence Members of Congress to block legislative proposals that would have stripped them of their preferential advantages. The GSEs even paid lobbyists just so they would not lobby against them."⁷⁸ Reportedly, GSEs

⁷³ Office of the Comptroller of the Currency National Credit Committee, 'Survey of credit underwriting practices', (June 2005), 5-6

⁷⁴ Peter Wallison, 'Government housing policy and the financial crisis', (Spring/Summer 2010), Cato Journal, Vol. 30, No. 2, 397-406, 402

⁷⁵ Ibid, 402

⁷⁶ Supra, note 71, (McDonald), 334

⁷⁷ Supra note 65, (Min), 4

⁷⁸ Supra note 58, (Issa), 14-15

could act very determinedly: “Fannie has this grandmotherly image, but they’ll ... tie you up and throw you in the Potomac. They’re absolutely ruthless.”⁷⁹

As already mentioned in earlier chapters the housing bubbles were significantly more pronounced in four states (Arizona, California, Florida and New Mexico) in the run-up to the financial crisis.⁸⁰ The crisis followed the pattern described by Minsky due to the ready availability of credit, low interest rates and a speculative housing mania. The process was further fuelled by additional credit provided by financial innovation and politically supported GSEs. Aspects of this latter element could be seen in cross-party and Presidential support for homeownership as an aspiration for all and reinforced by the work of, in particular Freddie Mac and Fannie Mae.

7.7 Opposition to reforming the GSEs

Following the crisis the US GSEs remain largely unreformed and large amounts of their securities are held by the Federal Reserve.⁸¹ Any change is opposed from a number of sides.⁸² Support for the GSEs comes from a broad front of interested groups. For example, since the increase in the availability of credit produced higher house prices, the main beneficiaries were “real estate brokers, builders, building labor, the suppliers of building materials and speculators”.⁸³ For example, the web-site of the National Association of Realtors states, “Fannie and Freddie, despite their flaws, are helping the housing recovery. Getting rid of them doesn’t solve the problem...Making sure future homeowners have access to affordable home loans is good for the economy, and it’s good for home values.”⁸⁴ There appears to be a large enough coalition to prevent any significant changes

⁷⁹ Owen Ullmann, ‘Crony capitalism: American style’, (July/August 1999) *The International Economy*, 7

⁸⁰ Haughwout and others, ‘Real estate investors, the leverage cycle and the housing market crisis’, chapt 3, n6

⁸¹ Almost 40% of total balance sheet assets, (\$1,736 Bn out of total balance sheet assets of \$4,454 Bn) Quarterly Report on Federal Reserve Balance Sheet Developments, (November 2016), 4

⁸² *Supra*, note 65, (Min), 4-5

⁸³ Edward Pinto, ‘Fifty years of housing policy failure: how housing policies make homes unaffordable’, (October 2015) American Enterprise Institution’s International Centre on Housing Risk, 12

⁸⁴ National Association of Realtors web-site, ‘*The Future of Fannie Mae & Freddie Mac and What It Means for You*’, <http://homeownershipmatters.realtor/issues/the-future-of-fannie-mae-freddie-mac-and-what-it-means-for-you/>, (accessed 1 Feb 2017)

to the GSEs with reform seen as a “common enemy”.⁸⁵ As has been said “there is certainly more than enough blame to go around”.⁸⁶

Nevertheless, as considered in the next section, one GSE came out well from the financial crisis: the Veterans Administration (VA). There is no definitive answer to why this was the case but it may be that it was due to its regime of applying strict affordability criteria and tests to applications for its support and its use of independent property valuers. The VA's approach to lending may show a potential way forward for continuing Federal support of homeownership and reinforce the major theme of this thesis on the importance of conduct of business regulation in helping to ensure financial stability.

7.8 The “G.I. Bill” and the Veterans Administration’s promotion of homeownership

In order to avoid the economic disruption and the domestic political agitation among veterans experienced after the First World War the US government took a number of steps as the Second World War came to a close. These included the creation of the Veterans Administration mortgage insurance program as part of Servicemen’s Readjustment Act of 1944 (“G.I. Bill”).⁸⁷ The key purpose of this part of the legislation was set out in the preamble to the 1949 Housing Act stating the aim of providing “a decent home in a suitable living environment for every American family”.⁸⁸ This provided mortgage repayment insurance to veterans borrowing to buy or refurbish a home and essentially allows no-deposit loans.⁸⁹ The rationale was that service personnel would not have been paid enough during their period of service to afford a house deposit.

⁸⁵ Lorraine Woellert, ‘*The real estate lobby Is ready to rumble*’, “The housing lobby is mobilizing against its common enemy: a Republican plan to eliminate the federal government's guarantee of mortgages. "It's a coalition that's going to be very difficult for our adversaries to beat," says Jerry Howard, president and chief executive officer of the National Association of Home Builders. 'We're preparing for one hell of a fight.'” Bloomberg web-site, 3rd February 2011, <https://www.bloomberg.com/news/articles/2011-02-03/the-real-estate-lobby-is-ready-to-rumble>, (accessed 1st February 2017)

⁸⁶ Supra, note 18, (McCarty), 126

⁸⁷ Public law 346, chapter 268, S.1767

⁸⁸ Alex Schwartz, *Housing policy in the United States*, (Routledge, New York, 2006), 1

⁸⁹ Veterans Administration Loan Guarantee Guide, http://www.benefits.va.gov/BENEFITS/factsheets/homeloans/VA_Guaranteed_Home_Loans.pdf, (accessed 27th February 2017)

This important measure both increased house building and, as part of a much larger scheme, carried out a programme of social engineering with free university education and vocational courses and subsidised housing for some four million returning service men and women.⁹⁰ The Act has been amended over the years but its structure remains in place and its benefits continue to be available for veterans.

The results of the G.I. Bill are seen as transformational. Besides the access to free university and technical training the legislation permitted millions of men and women in their early twenties to buy their own homes and start families. A home of their own and the independence it provided became a mark of their new status and created “social capital” providing an inheritance for their children. “The G.I. Bill helped to engineer physical revolutions that ushered in a new ‘middle class’”.⁹¹

“Between 1940 and 1960, the fraction of all households that own the home they occupy increased from 44 to 62 percent”.⁹² The pattern of VA mortgage guarantees increased significantly until 1954 with the return of veterans from both the Second World War and the Korean War so that between 1949 and 1953 the VA had a share which averaged 24% of the new mortgages market.⁹³ Consequently, the VA programme played an important part in the growth of home ownership. However, there was a marked change in the period preceding the recent financial crisis.

The number of VA loan guarantees continued each year at between 250,000 to over 300,000 in 2004. Then at the height of the housing boom the annual numbers fell sharply to around 150,000 in 2005 and 2006 in marked contrast to that of Freddie Mac and Fannie Mae.⁹⁴ For example, the latter financed, in various forms, some 3.5m homes in 2005.⁹⁵

⁹⁰ Kathleen Frydl, *The GI Bill*, (Cambridge University Press, Cambridge, 2009), 263. See also Edward Humes, *Over here: how the G.I. Bill transformed the American Dream*, (Houghton Mifflin Harcourt, Boston, Massachusetts, 2006)

⁹¹ Ibid, (Frydl), 302

⁹², Matthew Chambers, Carlos Garriga and Don Schlagenhauf, ‘The New Deal, the GI Bill and post-war housing’, (2012), Society for Economic Dynamics, Meeting Papers, No. 1050, 2

⁹³ Ibid, (Chambers), 7

⁹⁴ Libby Perl, ‘VA housing’, (4th February 2013), Congressional Research Service, 10

⁹⁵ Fannie Mae, Securities and Exchange Commission 10-K report for the year to 31st December 2005, 3

Further, following the financial crisis, the VA's delinquency rates were very low at levels close to that for prime mortgages.⁹⁶

7.9 Assessment and conclusion

There appear to be a number of possible reasons for the VA's success including the VA's oversight of lenders and its selection of property appraisers.⁹⁷ However, the VA's loan underwriting process is the most likely reason for both the significant decline in housing guarantees in 2005 and 2006 and the low level of delinquency. Unlike the other GSEs the VA required both evidence of "reliable monthly income" and applied a detailed affordability test to determine whether the veteran had sufficient disposable income to meet both the mortgage costs and living expenses.⁹⁸

It is possible that the decline in underwriting standards in 2005 and 2006 by other GSEs and private sector lenders attracted veterans away from VA loan guarantees.

Consequently, there may have been a process of positive selection with the more fragile borrowers seeking help elsewhere. There may also be factors relating to the personal characteristics of former service staff. In addition, in some parts of the country the housing bubble inflated prices beyond the limits permitted by the VA. It may also be due to the activities of incentivised real-estate and mortgage brokers and the "targeted advertising" of subprime loans.⁹⁹ The whole issue is unexplored. Nevertheless, I submit that the application of documented affordability assessments coupled with sound property valuations were important factors in the success of the VA's approach to providing Federal

⁹⁶ US Congress, Evidence of Thomas Pamperin, Associate Deputy Under Secretary for Policy and Program Management, Veterans Benefits Administration, US Department of Veterans Affairs on 20th May 2010 to the House Committee on Veteran Affairs, Sub-committee on Economic Opportunity, <https://www.va.gov/OCA/testimony/hvac/seo/100520TJP.asp>, (accessed 29th June 2017)

⁹⁷ US Military, Veterans Administration, "*A look at the VA loan appraisal process*". See also Pamperin's evidence in *supra*, note 96, "VA's adherence to sound credit and underwriting principles prohibited the program from engaging in risky or subprime lending practices. Our strong lender oversight ensured that VA's mortgage-industry partners complied with these policies. Additionally, VA's panel of fee appraisers, who are assigned on a rotational basis and monitored by VA, ensures that home values are reasonable in light of market conditions"

⁹⁸ Veterans Administration, Lenders Handbook - VA Pamphlet 26-7, chapter 4

⁹⁹ US Congress, Testimony of Tim Embree, (Iraq and Afghanistan Veterans of America, Legislative Associate) on 20th May 2010, to the House Committee on Veteran Affairs, Sub-committee on Economic Opportunity, <https://veterans.house.gov/witness-testimony/tim-s-embree-0>, (accessed 29th June 2017)

assistance in the no-deposit mortgage market. The work of Di Maggio and Kermani tends to support this view.¹⁰⁰

If this hypothesis is correct for the VA, then it reinforces the importance of conduct of business regulation as a macroprudential tool in reducing the expansion of residential housing credit.

¹⁰⁰ Supra, note 44

CHAPTER 8

UK housing market: the political and macroprudential policy implications

“Better housing supply could also play a part in reducing economic volatility. Most major cycles in the UK economy over the past 30 years have been associated with instability in the housing market.”¹

8.1 The issue

“Almost every financial crisis has political roots.”² This is nowhere truer than in the UK’s housing market. In the course of interviewing a number of senior staff at mortgage lenders and other policymakers, many have commented that the UK housing market is “broken”. Similarly, a report issued in 2009 described the housing market as “dysfunctional”.³ A series of political acts of commission and omission have produced this result with severe implications for financial stability and macroprudential policy.

The central issue is that current household formation is running at approximately, 214,000 per annum for England alone.⁴ A projection in 2012 estimated that “the number of households in England will increase from 22.1 million in 2011 to 27.5 million in 2037”.⁵ This is an increase of 5.4 million, or 25%. “This implies that in 2037 we will need one additional home for every four that were in existence in 2011.”⁶ Another estimate is that

¹ Kate Barker, ‘*Delivering stability: securing our future housing needs*’, (March 2004) Barker Review Final Report, 18

² Chapt 3, n124, (Rajan, *Fault lines*), 7

³ Building and Social Housing Foundation (BSHF), *The future of housing*, (BSHF publication, Coalville, 2009) Report of a consultation meeting held between 23rd-25th June 2009 chaired by Lord Best, 6

⁴ Department for Communities and Local Government, ‘2014-based Household Projections: England, 2014-2039’, (12th July 2016), 1

⁵ Neil McDonald and Christine Whitehead, ‘New estimates of housing requirements in England, 2012 to 2037’, (November 2015), Town & Country Planning Tomorrow Series Paper 17, 18

⁶ *Ibid*, (McDonald and Whitehead), 18

the UK needs over 240,000 each year.⁷ The current estimate is that the UK needs to build some 290,000 homes each year until, at least, 2031 to address the back-log in house building and to meet future demand.⁸ In addition, another study used the terminology of “concealed households” to describe the existence of potential demand for housing including those living in overcrowded accommodation, older adults living with their parents, those in “unsuitable homes” (eg caravans, winter-let properties and the elderly and disabled unable to leave the accommodation due to access issues etc.) in addition to those actually homeless.⁹

In 2015 170,000 new homes were build; 133,000 by the private sector and 37,000 by housing associations and local authorities.¹⁰ This compares, for example, with over 240,000 build in 1980 and some 426,000 homes build in 1968, the highest number of dwellings constructed in any post-war year.¹¹ Some fifty percent of these homes were built by local authorities and housing associations. This level of construction is much lower than in other developed countries. For example, the UK constructed “only 3.6 homes each year per thousand people, between 1975 and 2013 compared with over 6 in France and the Netherlands and 5.4 in the USA.”¹²

Private sector building has not met the gap left by the demise of local government building which never recovered from a sharp decline in building in 1982 due to changes in central government policy. There have been earlier house building peaks. For example, between the two World Wars four million high-quality local authority homes were built together with a further 400,000 constructed by the private sector subsidised by taxpayers with an

⁷ Alan Holmans, ‘New estimates of housing demand & need in England, 2011 to 2031’, (2013) Town & Country Planning Tomorrow Series Paper 16, 5

⁸ Wendy Wilson, ‘Housing supply and demand: key issues for the 2010 Parliament’, (May 2010) House of Commons Library Research: Key issues for the new Parliament, 2010,, 76-77

⁹ Glen Bramley and others, ‘Estimating housing need’, (November 2010), Department for Communities and Local Government, 42-54

¹⁰ Department of Communities and Local Government, ‘House building tables’, (updated on 25th August 2016), Table 241, <https://www.gov.uk/government/statistical-data-sets/live-tables-on-house-building>, (accessed on 21st September 2016)

¹¹ Ibid, Table 241

¹² Thomas Aubrey, ‘The challenge of accelerating UK housebuilding’, (January 2015) Policy Network Paper, 4

additional 2.5 million homes privately built without subsidy.¹³ This represents some 350,000 houses constructed each year on average. There were further large-scale home building programmes immediately after the Second World War under the Attlee government and again in the 1960s as part of a programme of inner city slum clearances.¹⁴

This shortage of housing has resulted in significant growth in house prices and there is little evidence that current government ministers are over-concerned about this.¹⁵ In evidence to the House of Lord Select Committee the then Housing Minister said that “an awful lot of existing home owners will be very pleased” and “that [house] prices will continue to rise...the government’s aim is not to stop house prices rising, rather their priority is to encourage home ownership without cost to existing owners.”¹⁶ Instead the rise in prices has been fuelled by increased debt and “easy credit has been used as a palliative...by governments” and exemplified by the cynical phrase of “let them eat credit”.¹⁷

At the same time government policy has been to support increased demand for housing by a range of means including schemes to increase access to mortgages and taxation subsidies with capital gains and inheritance tax exemptions. In addition, the significant increase in the payment of housing credit has helped develop the private letting market. The consequence is that when a future housing bubble returns government action such as these will make it more difficult for macroprudential policies to be effective.

¹³ Derek Fraser, *The evolution of the British welfare state*, (Palgrave Macmillan, Basingstoke, 2009), 238

¹⁴ For the 1930s see Crafts and Fearon, ‘The 1930s: understanding the lessons’, 57, chapt 7, n16

¹⁵ Miguel Castro Coelho, Vigyan Ratnoo and Sebastian Dellepiane, ‘Housing that works for all: the political economy of housing in England’, (October 2014) Institute for Government, 10, “Property prices soared in England between 1982 and 1989 – approximately 80% growth in real terms. They fell sharply but briefly from 1989 to the mid-1990s (about 40% in real terms), and then increased again dramatically till the great recession in 2008 (about 150% in real terms). With soaring house prices came large increases in wealth for a vast number of homeowners. This experience is likely to have contributed to disseminating the idea that homeownership is a ticket for individual prosperity”

¹⁶ House of Lords Select Committee on Economic Affairs, *Building more homes*, (15th July 2016), 1st Report of Session 2016-17, HL Paper 20, 29

¹⁷ Chapt 3, n124, (Rajan, *Fault lines*), 9 and 21 and repeated by Mark Carney, ‘Three truths for finance’, remarks at the Harvard Club UK, Southwark Cathedral dinner, London, 21st September 2015

8.2 A possible way forward

The lack of housing in the UK presents a significant and continuing risk to financial stability. The scarcity of supply and property price inflation is coupled with increasing credit and it may be an area suitable for macroprudential review and intervention. The FPC lacks the statutory powers and, almost certainly, the political legitimacy, and hence will, to employ macroprudential policy to reduce the rapid growth in credit by increasing the supply of housing. Such a policy would be highly political since a significant rise in the number of new homes build over a number of years would have the effect of reducing the value of both new and the existing stock of homes. Nevertheless, this issue needs to be addressed since, as mentioned earlier, it goes to the very heart of the macroprudential risks within the economy.

However, the FPC could, in meeting its statutory objective, highlight this issue and the macroprudential consequences of failing to build sufficient homes over a long period and call for a serious long-term house construction strategy. This would send a signal to the markets and indicate the required direction of travel and progress, if any, would be clearly measurable. The FPC could provide an independent report on developments by the government of the day, over several Parliaments, to undertake the work to meet the objective.

In practice the scale of the problem is so large that that it would require significant political intervention, probably involving some form of government established “National Housebuilding Agency”.¹⁸ This could be financed by issuing government backed bonds. The Bank of England might deem these securities as acceptable for microprudential liquidity purposes and treat them favourably for risk weighted asset calculations. Further, the Bank might purchase such bonds as part of any future quantitative easing programme.

A combination of market failures and government actions in the UK housing market has had significant social and macroeconomic effects. These issues have been central to the strains placed on macroprudential and conduct of business policies. These are seen, in particular, in the areas of housing affordability and the levels of homeownership.

¹⁸ There are many other social benefits with type of programme. For example, the scheme run by Triodos Bank in the UK employing several hundred current and former prisoners, learning building skills constructing and renovating homes across the country and financed by the sale of these buildings, *The Scotsman*, “*Barlinnie inmates to build Glasgow social housing*”, (25th July 2015). Triodos is a Dutch commercial bank which also operates in the UK with a social and environmental purpose

8.3 Home affordability

The increase in housing costs, including rent, has had a significant macroeconomic effect. In the period 2002 to 2015 housing costs have “effectively wiped-out most if not all the ... income gains made by the bottom 56% of working age households”, although this picture is subject to wide regional variations.¹⁹ For households with the oldest person aged 25-44 over the same period real income growth has been on average £12 per week (2%) while housing costs have risen by £25 (25%).²⁰ In 1994 1.6 million UK households (10%) spent more than a third of their income on housing, both renting and paying mortgages, compared to 3.3 million (17%) in 2013.²¹ As mentioned earlier the percentage of households owning their own home has fallen from almost 70% just before the financial crisis to around 63% and continues to fall.

This has put a strain on both homeownership and rental affordability. As an approximation, housing costs that exceed 33% of household income are viewed as being on the cusp of affordability.²² For example, in London, in 2013-4, over 30% of household housing expenditure exceeds this limit compared only 9% in the lowest cost area of North East England.²³ The North West, Midlands and Wales formed a middle band of just under 15% of household housing expenditure exceeding a third of income.²⁴ UK household indebtedness levels remain very high at 140% of disposable income.²⁵ This compares with 104% in 2000 although there has been some deleveraging from 2007 when the equivalent figure was almost 160%.²⁶ In the USA the percentage is 115 and in Germany it is 82%.²⁷

¹⁹ Stephen Clarke, Adam Corlett and Lindsay Judge, *The housing headwind: the impact of rising housing costs on UK living standards*, (June 2016), Resolution Foundation, 6-7

²⁰ Ibid, (*The housing headwind*), 8

²¹ Lindsay Judge, *Housing affordability in the UK*, (April 2016) Resolution Foundation, 5-6

²² Christine Whitehead and others, *Measuring housing affordability: a review of data sources*, (April 2009), Cambridge University Centre for Housing and Planning Research, 7-9

²³ Ibid, (*Measuring housing affordability*), 25

²⁴ Ibid, (*Measuring housing affordability*), 25

²⁵ Daniel Harari, *Household debt: statistics and impact on economy*, (August 2016) House of Commons Briefing Paper, No. 7584, 10. The Bank of England, *Financial Stability Report*, (July 2016) 10, puts the percentage slightly lower at 132%

²⁶ Ibid, (Harari), 9

²⁷ Bank of England, *Financial Stability Report*, (July 2015), 23

House price inflation coupled with stagnant employment earnings has put homeownership beyond the aspiration of most younger UK citizens. For example, it has been estimated that a single person in their twenties earning an average wage would take almost thirty years to save for a twenty percent deposit in London, compared with, for example, over eleven years in the Midlands.²⁸ Depending on the assumptions used, it is estimated that first time buyers would need annual household salaries of approximately £45,000 by 2020 outside London and the South East in order to afford a deposit and mortgage.²⁹ This is some £20,000 in excess of where household income is now. In London the equivalent household salary would need to be over £100,000 per annum.³⁰

In summary, the continued rise in house prices and the growth of the rental sector and the increased share of household incomes used to pay for the cost of housing appears to constitute a misallocation of economy resources from more productive and societal beneficial employment.

8.4 Homeownership rates

The age profile of UK homeownership has fallen steeply. For example, in 1991 almost 70% of those aged between 25 and 34 owned their own home. This fell by half to 35% in 2013/14.³¹ The Council of Mortgage Lenders has similar figures: 62% of those aged between 25 and 34 owned their own home in 1993 compared with some 33% in 2013-4.³² In the 35-44 age group the equivalent percentage has fallen from 75% to 58%.³³ The National Housing Federation reported that “20% of all households own 64% of total housing wealth in Britain....and 63% of all housing wealth is owned by those aged 55 and

²⁸ Shelter, *A home of their own*, (January 2015), 10

²⁹ Shelter, *What salary will a typical first-time buyer need in 2020*, (April 2016), 4

³⁰ Ibid, (Shelter *What salary*), 4

³¹ Office of National Statistics, ‘UK Perspectives 2016: Housing and home ownership in the UK’, (25th May 2016), <http://visual.ons.gov.uk/uk-perspectives-2016-housing-and-home-ownership-in-the-uk/>, English Housing Survey (EHS), Table FC21010 DCLG ; EHS 2001/02, Table S106, DCLG, (accessed 1st July 2017)

³² Council of Mortgage Lenders (CML) web-site, ‘Data shows housing tenure trends continuing’, (5th March 2015), Chart 2, <https://www.cml.org.uk/news/news-and-views/710/>, (accessed 22nd September 2016)

³³ Ibid, (CML) Chart 2

over.”³⁴ The inequality of asset distribution in the UK tends to support the view that “for unto every one that hath shall be given, and he shall have abundance...”.³⁵

Nevertheless, the aspiration to own a home of ones’ own remains high. There remains a “deep-seated sentiment towards home-ownership.”³⁶ Some 80% of adults aspire in the UK to own their own home within the next ten years.³⁷ Since these surveys started in 1993 this aspiration has not changed.

8.5 Government intervention

The government has accepted that the UK’s housing market is not functioning properly and in February 2017 it issued a White Paper stating that “our housing market is broken and the cause is very simple: for too long, we haven’t built enough homes. Since the 1970s, there have been on average 160,000 new homes each year in England. The consensus is that we need from 225,000 to 275,000 or more homes per year to keep up with population growth and start to tackle years of under-supply.”³⁸ However, the proposed remedies are very limited and piecemeal with a focus on encouraging local authorities to commit to planning for more homes, penalising developers who are slow to build once they have planning permission and increasing competition among private sector builders.³⁹ The proposals have been criticised as inadequate and unlikely to make much difference to the severe housing problem.⁴⁰

³⁴ National Housing Federation Research Paper, ‘Intergenerational perspectives on housing wealth’, (September 2016), 1

³⁵ Matthew 25, 29, King James’ Version

³⁶ Council of Mortgage Lenders, ‘Still aspiring’, (10th April 2013) YouGov survey report

³⁷ Ibid, (CML survey)

³⁸ Department for Communities and Local Government White Paper, “*Fixing our broken housing market*”, (Cmd 9352, February 2017), 9

³⁹ Ibid (White Paper), 16-17

⁴⁰ The Guardian, “*The Guardian view on the housing white paper: it won’t fix a broken market*”, (7th February 2017), “such is the crisis that cabinet ministers call for ambitious, radical reforms to “turn things around”. The trouble is, there aren’t any in the white paper”

The central issue was described in the Lyons report which said that governments continue to be faced with an “insider problem” in that a large increase in housing provision would affect current house prices and damage “the economic interests of existing householders and landowners.”⁴¹ Moreover, “older owner occupiers are more likely to vote than those in socially or privately rented housing meaning they have often had a louder voice.”⁴²

The then Housing Minister, Brandon Lewis, said that by 2020 the UK would seek to build around a million extra homes.⁴³ However, a Parliamentary report in 2016 said that this target would be insufficient and that “to address the housing crisis at least 300,000 new homes are needed annually for the foreseeable future”.⁴⁴

Much of the housing development industry came close to financial collapse during the recent financial crisis due to a combination of heavy gearing and a sharp decline in asset values. This resulted in the government providing extensive financial support to the industry. Following the recent financial crisis, the government has initiated twenty-one schemes specifically to support the housing market.⁴⁵ These have provided almost £32 billion in grants, loans and guarantees of which the vast majority (£25 billion) has been allocated to supporting demand for housing in the form of “Help-to-Buy” loans and tax incentive schemes.⁴⁶ The balance has been used to increase housing supply by, for example, encouraging developers to restart “stalled” housing developments (“Kick Start 1 and 2”) and providing finance to developers and builders (“Get Britain Building”).⁴⁷ These initiatives appear to have helped large developers and builders through the financial

⁴¹ The Lyons Housing Review, *‘Mobilising across the nation to build the homes our children need’*, (October 2014), 15

⁴² Ibid, Lyons Review, 15, See also Herman Schwartz and Leonard Seabrooke, ‘Varieties of residential capitalism in international political economy: old welfare states and the new politics of housing’, (2008) *Comparative European Politics*, 6, 237-261, 239 which discusses “asset-based welfare”

⁴³ The Architect’s Journal, *“Housing minister targets 1 million new homes by 2020”*, (21st September 2015)

⁴⁴ Supra, note 16, House of Lords, *“Building more homes”*, 5

⁴⁵ Shelter, *‘Achieving the ambition: building one million homes this Parliament’*, (August 2016), 10

⁴⁶ Ibid, (*‘Achieving the ambition’*), 10-11

⁴⁷ Home & Communities Agency, *‘Kickstart’* web-site, <http://webarchive.nationalarchives.gov.uk/20140805133148/http://www.homesandcommunities.co.uk/ourwork/kickstart>, (accessed 14th July 2017). The aim of this scheme was to building 16,000 houses. See also Home and Communities Agency, *‘Get Britain Building: programme prospectus’*, (December 2011). This scheme ended after building 12,000 homes

crisis.⁴⁸ Large firms were generally better able to navigate the application process for these funding schemes and this may have been one of the reasons for the demise of many small builders and a wide-spread consolidation in the construction industry.

The housing development and building market has been described as “oligopolistic” with the eight largest firms building over 50% of homes and continuing to expand by acquiring small businesses.⁴⁹ However, an Office of Fair Trading study in 2008 concluded that there were no significant competition issues or barriers to entry.⁵⁰ It stated that “on a national basis, concentration in the industry is low by comparison with that in many other consumer goods manufacturing industries. In 2006, the single largest firm supplied 11 per cent of the market and the top ten firms supplied 44 per cent of total supply. The 75 largest firms (all of whom produce 100 units a year or more) supplied about 63 per cent of output and roughly a quarter of supply was accounted for by a long 'tail' of about 5,000 firms.”⁵¹

In addition, access to land is central to the housing development business model. Land is acquired by direct purchase and, more importantly, by a complex and opaque system of options. The scale and the obscurity of these contracts may, in themselves, pose a threat to financial stability and, consequently, would be worthy of study by the Financial Policy Committee. Moreover, a significant reason for consolidation in the development and building industry is the ability to access both current and strategic land banks.⁵² This is considered in more detail later.

8.6 Government Housing Benefit

Government intervention in the housing market also takes the form of housing benefit payments (rent payments) for those with very low incomes with minimal savings and in rented accommodation. Approximately £24.7 billion was paid out in government housing

⁴⁸ Supra, note 45, (Shelter, ‘*Achieving the ambition*’), 10

⁴⁹ Supra, note 16, (House of Lords report), 8

⁵⁰ Office of Fair Trading, “*Homebuilding in the UK: a market study*”, (September 2008), 6

⁵¹ Ibid, OFT study , 57

⁵² KPMG, ‘*Homebuilding market study: Annex E - Study investigating financing for homebuilders*’ in the OFT’s 2008 survey, 39, supra note 50

benefit in 2014/5.⁵³ Of this, £9.1 billion (37%) was paid to private landlords.⁵⁴ “Using 2013/14 prices, spending on housing benefit has risen from £16.5 billion in 1996/97 to £24.4 billion in 2012/13 – a 48 per cent real terms increase.”⁵⁵ The point has been made by a number of people and organisations that this latter sum could be used to construct some 100,000 houses each year.⁵⁶ This can be summarised as a move away from investment in house building to an ongoing process of rent subsidies.

8.7 The role of developers and construction firms

The Office of Fair Trading have said that “large homebuilding businesses are driven by their land acquisition units with key corporate decisions on expansion, mergers and financial structuring most heavily influenced by the need to acquire land” and it is more appropriate to think of the industry as consisting of “land developers who have integrated downwards into home construction rather than housebuilders who have ventured into land development.”⁵⁷ Besides the issue of industry consolidation, mentioned above, there are significant concerns that the housing development sector severely restricts construction in order to maintain its profitability. It does this by acquiring options on large amounts of development land and rations the building of homes on land even where planning permission exists with a consequential effect on house prices. For example, it has been reported that over “475,000 homes with planning permission still waiting to be built”.⁵⁸ About a third of all successful planning applications for homes are never built.⁵⁹

⁵³ Department of Work and Pensions (DWP), ‘Housing benefit expenditure’ in ‘Benefit expenditure and caseload tables 2016’, (September 2016), <https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2016>, (accessed 23rd July 2017)

⁵⁴ Ibid, (DWP data)

⁵⁵ Chartered Institute of Housing, ‘*Ticking the box for a welfare system that works*’, (September 2014), 4

⁵⁶ Ibid, (“*Ticking the boxes*”). See also Nick Pearce, ‘*Housing benefit is out of control, but there is an alternative*’, (The Guardian, 21st June 2012) and Hilary Benn MP, Housing debate, House of Commons, 8th January 2014, column 328

⁵⁷ Supra, note 50, (OFT Study), 84

⁵⁸ Local Government Association web-site, http://www.local.gov.uk/media-releases/-/journal_content/56/10180/7632945/NEWS, (accessed 29th September 2016)

⁵⁹ Supra, note 16, (House of Lords report), 23

Nevertheless, the industry remains high-risk due to the amount of gearing it requires to finance land acquisition and construction work. Development and building firms have different gearing levels depending on their ownership. For example, those which are publicly listed have gearing levels which vary between 10% and 40% of total capital compared with those which are financed by private equity where the average is around 100%.⁶⁰ There is also evidence that “year end net debt is typically lower than average net debt.”⁶¹ This could be due to management performance targets which result “in a push for completions at year-ends to achieve bonus targets and meet investor expectations.”⁶² As mentioned the housing development industry suffered very badly during the financial crisis. Following the financial crisis Taylor Wimpey, Persimmon, and Barratt all had to renegotiate debt terms with their bankers and refinance at high rates of interest.⁶³ Due to the lack of public information it is difficult to say what happened to those developers owned by private equity operations but their higher levels of gearing are likely to have hit them even harder. It is estimated that land write-downs for the big six publicly quoted developers totalled approximately £15 billion.⁶⁴

8.8 Land options and the possible threat to financial stability

The land market is one of the key elements to increasing the supply of housing. Currently, the land options system is completely opaque. It is unclear who owns what options at what price. This is an area that has been little studied. It is possible that the extent of these options, their cost and financing may constitute a threat to financial stability. Similarly, without government intervention it is likely that a number of large developers would have collapsed as the recent financial crisis spread with consequential effects on lenders and the value of housing land and developments. This may constitute a significant threat to future financial stability and, at the very least, this is an area which would be worthy of review by the FPC.

⁶⁰ Supra, note 52, (KPMG survey), 63-69

⁶¹ Ibid, (KPMG survey), 71

⁶² Ibid, (KPMG survey), 71

⁶³ Financial times, ‘*Rate cuts fail to lift house sales, says Bellway*’, (4th December 2008)

⁶⁴ Matt Griffith, ‘*We must fix it: delivering reform of the building sector to meet the UK’s housing and economic challenges*’, (December 2011), Institute for Public Policy Research, 19-20

8.9 The profitability of developers

UK housing developers depend on a business model largely dominated by the cost of land and financed with debt. With an ability to limit housing supply coming onto the market it is able to produce high returns on equity. Consequently, the model has been described as "dysfunctional [and] broken", relying "on ever growing credit" and the rise in value of the underlying land.⁶⁵ The view is that the most profitable part of "residential property development is land ownership rather than the construction of houses".⁶⁶ In addition, it is difficult to determine what level of funding is provided by "land creditors" where developer payments to landowners or option holders is deferred and thus provides a form of debt development finance.⁶⁷

Most developers "prefer to concentrate on smaller levels of controlled output at larger margins" rather than increase the level of building.⁶⁸ This is a rational strategy for the companies concerned in view of the risks they run, as seen during the recent financial crisis. "As one housebuilder put it when interviewed about its growth strategy: 'We'll double in size, but halve the margins, so what's the point?'"⁶⁹

A review of the recent results from six of the largest development and housing firms in the UK in the financial year ending in 2016 indicated high rates of return of around 27% with Persimmon leading the pack with a 35.6% rate of return on capital employed (ROCE).⁷⁰ These levels of ROCE are generally high compared to other capital intensive businesses

⁶⁵ Alex Morton, *'Cities for growth: solutions to our planning problems'*, (2011) Policy Exchange, 69

⁶⁶ Supra, note 12, (Aubrey), 4

⁶⁷ Supra, note 52, (KPMG survey), 70-71

⁶⁸ FTI Consulting, *'Understanding supply constraints in the housing market'*, (July 2012), 23

⁶⁹ Fred Wellings, *British housebuilders: a history and analysis*, (Blackwells, Oxford, 2006) quoted in Griffiths, 'We must fix it', 29, supra, note 64

⁷⁰ Construction firm financial statements;

- Barrett Developments, 'Final results for the year ended 30th June 2016',
- Bellway plc, 'Interim results for the half-year to 31st January 2016',
- Berkeley Group Holdings plc, 'Preliminary results announcement, June 2016',
- Persimmon plc, 'Half year results for the six months ended 30 June 2016',
- Redrow plc, 'Full year results to 30th June 2016'

such as 11% at GKN and Coats Group for the year to 31st December 2015 and 20.8% for Smiths Group for the year to 31st July 2015.⁷¹

The importance of the cost of land can be seen in the costing model in which it is estimated that land acquisition costs account for about 30% of a house developer's income, with construction costs accounting a further 40% with interest payments and overheads taking up a further 10% of the total leaving a 20% profit on average.⁷² The cost of land as a percentage of the total has risen significantly over the last fifty years.⁷³

8.10 The allocation of land “development gain”

Once planning permission has been granted for development agricultural land increases many times in value. For example, farm land in Oxfordshire with planning permission for residential housing construction will have a value of £4m per hectare compared with only £20,000 in its currently agricultural use.⁷⁴ The increase in value is retained, in full, by the vendor. If they are a farmer the proceeds can be rolled over and invested in the business and capital gains tax avoided.

Further, under the provisions of the Land Compensation Act 1961, as amended by the Land Compensation Act 1973, the landowner whose land is subject to compulsory purchase also gets the value increase arising as a result of any planning assumptions made about the future use of the land.⁷⁵

There has been considerable concern about who gets this increase in value dating back to at least the mid-19th century.⁷⁶ Essentially, the increase in land value (known as “planning

⁷¹ London Stock Exchange web-site, <http://www.londonstockexchange.com/exchange/prices/stocks/summary/fundamentals.html?fourWayKey=GB0030646508GBGBXSET1>, (accessed 28th September 2016)

⁷² Supra, note 52, (KPMG survey), 31

⁷³ Supra, note 12, (Aubrey), 4

⁷⁴ KPMG and Shelter, *‘Building the homes we need’*, (2014), 33. See also Farmers Weekly, “Well-positioned parcels with planning permission have sold for as much as £1m/acre [£400,000 per hectare] in the south of England and £600,000/acre further north, while land in north Wales has gone for 50 times its agricultural value.” (23rd January 2015)

⁷⁵ Part II, ss 5 and 6

⁷⁶ John Stuart Mill, *Principles of political economy*, (published 1848, Oxford University Press, 1994), 183-184

gain” or “betterment”) arises due to the planning decision not because of any action by the owner. In 1947 this increase in value was taxed at a rate of 100% but this tax was abolished in 1953 following a change in government. There have been subsequent attempts by incoming Labour governments in 1964 and 1974 at taxing betterment but these have yielded very little since “the administration was complex, tax avoidance was widespread [and] land was withheld from the market (in part in the hope of a change of government and hence policy)”.⁷⁷ Each initiative in this area has then been repealed by subsequent Conservative governments.⁷⁸

More successful have been the bilateral negotiations between developers and local authorities using powers under section 106 of the Town and Country Planning Act 1990. Section 106 arrangements are a transfer of economic rents and is a form of “negotiated tax”.⁷⁹ This has proved a useful source of income for local authorities since the funds accrue locally rather than go to the Exchequer.⁸⁰ Much of the cost of the infrastructure for the housing project falls on the local authority (eg utilities, transport, schools) and consequently, some of the development gain is repaid to the local authority which is meant to support the provision of these additional services.

There are powers for local authorities to require land for development to be offered first to the local authority. These requirements are being used more frequently with, for example, the percentage of cases doubling from 33% in 2000 to 68% in 2006.⁸¹ However, it is questionable as to its efficiency and effectiveness. It appears that local authorities hold considerable amounts of land suitable for house building but “are constrained from building council homes on the land by their debt caps.”⁸²

⁷⁷ Tony Crook and Sarah Monk, ‘Planning gains, providing homes’, (2011) *Housing Studies*, Vol. 26, Nos. 7–8, 997–1018, 1001

⁷⁸ A. R. Prest, *The taxation of urban land*, (Manchester University Press, 1981), 89-96

⁷⁹ *Supra* note 77, (Crook and Monk), 1012

⁸⁰ Edwin Buitelaar, ‘Crack in the myth: challenges to land policy in the Netherlands’, (2010), *Tijdschrift voor Economische en Sociale Geografie*, 101(3), 349–356, 352. For example, in 2005 it accounted for 12% of local government income

⁸¹ Sarah Monk and others, *‘International review of land supply and planning systems’*, (March 2013) Joseph Rowntree Foundation, 65

⁸² *Supra* note 74, (KPMG/Shelter), 76. See also Andy Hull, (Institute for Public Policy Research) in written evidence to: Communities and Local Government Committee, *Financing of new housing supply: Eleventh Report of Session 2010-12* (The Stationary Office, London, 2012)

Nevertheless, while some local authorities are keen to build housing, others “are out of the game altogether”.⁸³ This may be because some local authority councils face a dilemma between wanting to build more homes and “being thrown out at the next election” for doing so.⁸⁴

8.11 Options for increasing the supply of housing in the UK

As mentioned earlier, credit provides the fuel to activate latent demand which may increase the price of housing and in turn may motivate existing homeowners to sell and developers to build new homes. As discussed, the increase in the supply of housing may have both a macroprudential effect by increasing financial stability and a positive conduct of business outcome as borrowers would not need to stretch themselves financially as much.

In recent years there has been no lack of high-quality reports of what to do. For example, Sir Michael Lyons published his “Housing Review: Mobilising across the nation to build the homes our children need” (“Lyons”) commissioned by the then leader of the Labour party in 2014.⁸⁵ More recently, The House of Lords Select Committee on Economic Affairs issued their report, “Building more homes”, in July 2016.⁸⁶ In addition, the Labour Party Shadow Housing Minister initiated a further review by Peter Redfern which was published on 16th November 2016.⁸⁷

While this is not a thesis on solving the housing crisis in the UK it is important to consider, albeit briefly, the obstacles and possible solutions to increasing the supply of housing and hence addressing both a macroprudential and conduct of business problem. Kate Barker

⁸³ Supra, note 16, Lord Best’s evidence to the House of Lords Select Committee, 55

⁸⁴ Supra, note 16, evidence by Kate Barker to the House of Lords Select Committee, 38

⁸⁵ Supra, note 41, (Lyons)

⁸⁶ Supra, note 16, (House of Lord Report)

⁸⁷ City AM, ‘*Taylor Wimpey chief executive Pete Redfern launches a major review into UK home ownership with Labour shadow minister John Healey*’, (4th February 2016). See Peter Redfern, ‘*The Redfern Review into the decline of homeownership*’, (November 2016)

made the point in her 2004 report that the supply of land for housing does not appear to be responsive to price signals.⁸⁸ For example, between 1990 and 2010 the supply of new land for housing fell by 63% in spite of house prices increasing by more than 300%.⁸⁹ Another report described the current housing market as “asymmetric ... the price of housing goes up but it is not met by an increase in home building.”⁹⁰ Moreover, there is a view that UK housing is badly distributed.⁹¹ All of this is having severe, and increasingly bad, socioeconomic effects. If this issue can be addressed and the major market failures corrected then the supply of housing can be significantly increased and the need to increase credit reduced with positive results for macroprudential policy and financial stability.

There are a number of issues with the current broken housing market and the lack of housing supply. These are considered next.

8.12 Issues preventing increasing house building

8.12.1 Access to land for development

Lyons refers to an “artificial scarcity of land for housing [which] has created distortion in the land market, limiting the rate at which new homes are built and incentivising the acquisition and trading of land.”⁹² Currently the eight largest house builders each own around five years supply of land for development and a wider range of options on land for a further five to fifteen years.⁹³ This means that “large amounts of land suitable for development are tied up in option agreements and therefore not available to other developers.”⁹⁴ There are many intermediaries in the process of acquiring land and there is little or no transparency

⁸⁸ Supra, note 1, (Barker), 25

⁸⁹ Shelter, ‘*Response to the Lyons review of housing supply*’, (2014) 3, using Office of National Statistics and Department of Communities and Local government data

⁹⁰ Supra, note 68, (FTI Consulting), 15

⁹¹ Danny Doring, *All that is solid*, (Penguin, London, 2014) 99 and 105-115, who considers that there are sufficient houses but they are inefficiently allocated or simply in need of refurbishment

⁹² Supra, note 41, (Lyons), 6

⁹³ Supra, note 41, (Lyons), 61

⁹⁴ Supra, note 41, (Lyons), 62

as to who own what rights over land and the pricing structures of these rights. For example, it has been calculated that six land agents hold options over some 60,000 hectares suitable for constructing between 300,000 to 400,000 homes.⁹⁵ Some of this land many have planning permission for building but remains undeveloped. This issue is considered in more detail later in this section.

8.12.1 Where to build

Only 8.5% of UK land is designated as urban and of this only 1.1% of the total is built on for residential purposes. Some 4% is covered by rivers, lakes, infrastructure etc and 87.5% is farm land and other “green space” (within this some 13% is green belt land).⁹⁶ There appears to be capacity for large-scale housing development in areas where jobs exist and people want to live (eg East Anglia, Hampshire and Bedfordshire, Hertfordshire and much of the Midlands) but these are also areas with the highest land prices outside places such as London, Oxford etc.⁹⁷

The popular view is that England is in the process of being concreted over to build houses.⁹⁸ However, contrary to this perception the UK is not over-crowded and even the most high-density areas in the South East of England have fewer people per square kilometer than many parts of the Netherlands, Belgium, Switzerland and Germany.⁹⁹

8.12.3 Brown and green field site development

Significant capacity to build exists on “brownfield” sites which have no other development use. One recent study estimates that there is space for approximately one million homes

⁹⁵ Supra, note 41, (Lyons), 62

⁹⁶ Quoted in Lyons review, supra, note 41, 35

⁹⁷ Glen Bramley and David Watkins, ‘Where should we build the extra housing we need in England? Need, demand, opportunity and value’, (April 2014) Housing Studies Association conference at Heriot Watt University

⁹⁸ Campaign to Protect Rural England, ‘*Building on Barker: how we can continue to improve housing for everyone without damaging the environment and sprawling over the countryside*’, (January 2005), 33 “Every year 21 square miles of open, undeveloped, green land... is built over in England” and this is mainly for housing

⁹⁹ Kristian Niemietz, ‘Abundance of land, shortage of housing’, (April 2012) Institute of Economic Affairs Discussion Paper No. 38, 6-7

on such land.¹⁰⁰ While the National Land Use Database indicates capacity for almost 1.5 million homes on derelict land and of this some one third would be in London and the South East.¹⁰¹ However, there is also considerable dispute over the availability of brownfield sites for housing development with the National Housebuilders Federation estimating “that of the 49,000 hectares of brownfield land in England, 23,500 hectares are suitable for use for housing. Noting this a Parliamentary Committee report said that this would be enough land for approximately one million homes, or four and a half years of housing demand...”.¹⁰²

The same Parliamentary report commented that “the lower viability and higher costs of developing brownfield sites may be a deterrent for some developers..” and the Committee had “particular concerns about the risk that developers will delay developing brownfield sites because local authorities will be required to release more profitable greenfield sites if insufficient housing is delivered to meet local needs.”¹⁰³ Developers tend to favour residential developments on greenfield sites since it is generally easier to undertake. Greenfield land is usually subject to a single owner, does not require decontamination and site logistics present fewer problems. In contrast, using previously developed land for housing is more difficult and costly and may take longer.¹⁰⁴

Consequently, moves to open “Green Belt” sites surrounding some UK cities appears to be a distraction from the main issues.

8.12.4 Planning process

Again contrary to expectations the planning process itself does not appear to cause undue delays in the process of building. Reports indicate that planning consent can usually be

¹⁰⁰ Alex Morton, ‘Why aren’t we building enough attractive homes? Myths, misunderstandings and solutions’, (2012) Policy Exchange, 11

¹⁰¹ University of the West of England, sponsored by the Campaign for the Protection of Rural England (CPRE), ‘*From wasted space to living spaces: the availability of brownfield land for housing development in England*’, (November 2014), CPRE, 8

¹⁰² Parliamentary Select Committee on Communities and Local Government’s Report on the ‘*Department for Communities and Local Government’s consultation on national planning policy*’, (April 2016) Third Report of Session 2015–16, 13

¹⁰³ Ibid, (Select Committee), 12

¹⁰⁴ Supra, note 1, (Barker), 58

obtained in around sixteen weeks.¹⁰⁵ However, the negotiations on payments under Section 106 of the Town and Country Planning Act 1990 and agreements under the Growth and Infrastructure Act 2013 can take between an additional 22 and 44 weeks.¹⁰⁶ The total lead time to getting planning consent could be a year including certifying compliance with the various planning conditions. Once planning agreement is given developers have approximately three years to start work but “any material operation” is sufficient to satisfy this requirement and there is no time limit on completing the work.¹⁰⁷

8.12.5 Taxation

The taxation system has an indirect effect on the housing market with a regressive council tax scheme with proportionally more of the tax falling on owners of lower value properties.¹⁰⁸ In addition, there have been proposals to change the taxation system to remove current taxation subsidies for existing home-owners by, for example, the capital gains exemption granted to primary residence sales and deferred inheritance taxation.¹⁰⁹

8.12.6 Land acquired for development but not developed at all or quickly

The Lyons review found that there were “6,700 sites (containing more than ten homes) with planning permissions that have not yet been completed. These sites have the capacity for 588,000 homes.”¹¹⁰ Some “50,000 of these homes are on sites that are classified as on hold or cancelled, 246,000 are progressing towards construction and 271,000 are on sites that have already started construction. A further 21,000 are on sites that are for sale, have been recently sold or have no information available. In addition to the 50,000 homes that are on identified stalled sites, however, 80,000 unbuilt homes have had planning permission in 2010 or earlier. Of these there are 26,000 homes on sites that have yet to start and 54,000 homes on sites that have started but have not yet completed. In total this means there are 130,000 homes with planning permission, equating to 22% of the total that are either on hold or have been in the system for more than 4 years...[and in

¹⁰⁵ Supra, note 16, (House of Lords report), 39

¹⁰⁶ Supra, note 16, (House of Lords report), 39

¹⁰⁷ s56(4) Town and Country Planning Act 1990

¹⁰⁸ Supra, note 16, (House of Lords) 6

¹⁰⁹ Supra, note 3, (BHSF, *The future of housing*), 23-24

¹¹⁰ Supra, note 41, (Lyons), 65

addition there] were 270,000 homes on sites that have been in the planning system since 2010 or before which have not yet progressed to planning permission.”¹¹¹

There was an interesting review undertaken in 2014 following up an earlier 2012 survey in Greater London.¹¹² In mid-2012 there were 531 housing schemes which had yet to commence and this cohort of projects was examined again in 2014 to see how they were progressing during a period of rapidly rising property prices and high demand. Although building had started on 262 sites 231 of the remainder were “on-hold” and a further twenty-five sites the planning permission originally granted had lapsed and in thirteen instances planning permission applications were either also on-hold or were being progressed.¹¹³

8.12.7 Lack of skilled builders

There is a severe skills shortage in the construction industry due to lack of investment in training. In 2016 59% of member firms of the Royal Institute of Chartered Surveyors reported continuing skills shortages which are above the historic average of 43%. This is particularly acute when trying to find both surveyors and bricklayers.¹¹⁴ The problem is exacerbated by the industry’s age profile. The Construction Industry Training Board (CITB) estimated that some 400,000 construction workers will retire over the next ten years.¹¹⁵ This issue is compounded by the results of a survey which indicated that around 60% of house builders had significantly cut training budgets and 49% have no plans to invest in new training.¹¹⁶

¹¹¹ Supra, note 41, (Lyons), 65

¹¹² Mayor of London, ‘*Barriers to housing delivery - update: private sector housing development on larger sites in London*’, (July 2014), Greater London Authority, 13. See 2012 report, Mayor of London, ‘*Barriers to Housing Delivery*’, (December 2012), Greater London Authority, 9

¹¹³ Ibid, (Mayor of London), 13

¹¹⁴ Royal Institute of Chartered Surveyors (RICS) ‘UK Construction Market Survey’, (Q1 2016)

¹¹⁵ Construction Industry Training Board web-site, ‘*UK construction industry facing skills timebomb*’, (8th August 2013), <http://www.citb.co.uk/news-events/uk-construction-skills-time-bomb/>, (accessed 4th November 2016)

¹¹⁶ Ibid, (CITB web-site)

Mirroring this, the number of people starting construction, planning and built environment apprenticeships has halved since 2006/07 with fewer than 10,000 people completing a construction apprenticeship in 2012/13.¹¹⁷

In view of these problems, in July 2016 the Parliamentary Select Committee on Communities and Local Government started an enquiry into capacity of the homebuilding industry to meet the demand for new homes.¹¹⁸

8.12.8 Use of outdated labour intensive building methods

As mentioned in an earlier chapter, house building methods have not changed significantly for a hundred or more years. Ball notes that “innovation in the ways that houses are constructed is relatively slow.”¹¹⁹ This means that building homes is very labour intensive with a high demand for skilled workers. However, it is reported that these are simply not available in the necessary number thus delaying house building.¹²⁰ This may well be because, “for an industry where the key focus may be on land management rather than production, innovation may not have the same priority as other industries.”¹²¹ This has produced some problems in the supply chain for construction products such as bricks.¹²² However, these appear to be short term issues.¹²³

¹¹⁷ Supra, note 74, (KPMG/Shelter report), (Skills Funding Agency data on sector specific apprenticeship starts and completions), 44

¹¹⁸ Commons Business Select Committee, ‘Capacity of the homebuilding industry inquiry launched’, (5th July 2016), <http://www.parliament.uk/business/committees/committees-a-z/commons-select/communities-and-local-government-committee/news-parliament-2015/homebuilding-launch-16-17/>, (accessed 3rd July 2017)

¹¹⁹ Michael Ball, ‘*The housebuilding industry: promoting recovery in housing supply*’, (2010) a report for the Department of Communities and Local Government, 11

¹²⁰ Financial Times, ‘*Shortage of builders hobbles UK housing ambitions*’, (3rd February 2015), Daily Telegraph, ‘*Shortage of builders holding back development, says housebuilder*’, (17th November 2015)

¹²¹ Supra, note 68, (FTI Report), 27

¹²² ‘*Britain faces bricks shortage, builders warn*’, (Telegraph, 29th April 2014)

¹²³ Submission by the Modern Masonry Alliance (MMA) an industry trade body to the Lyons review, supra note 41, 116

The lack of innovation presents buyers with a limited choice of designs. In many ways this reflects the wishes of conservative consumers and the need to ensure ease of resale.¹²⁴ Nevertheless, it is possible to build relatively cheaply in the UK “using modern technology so that a 1,000 square foot housing unit can be constructed for less than £100,000.”¹²⁵ However, there is no pressure on builders to produce anything new since due to housing scarcity anything they design and built will be sold. Moreover, developers are more likely to obtain planning permission if they keep to traditional designs.¹²⁶ Buildings follow standard formats which are low-cost to design but construction is bespoke with few moves toward off-site modular construction.¹²⁷ In addition, the production and assembly of housing components constructed off-site requires housebuilder and sub-contractor investment in staff training and competences. The industry is not structured to do this and has traditionally not invested in these areas.¹²⁸

House building in the UK did go through a period of dynamic growth just as the Second World War ended employing new building methods including pre-fabrication.¹²⁹ However the pace was not maintained and house building reverted to its traditional means of construction as the emergency housing programme came to an end.¹³⁰ However, a number of European towns and cities have experimented with new methods of housing development and building innovations.¹³¹ For example, Almere in the Netherlands has set

¹²⁴ Michael Ball, ‘Chasing a snail: innovation and housebuilding firms strategies’, (1999), *Housing Studies* 14: 9–21, 12–14

¹²⁵ Legal and General, ‘*Let’s house Britain*’, (2014) UK Housing Crisis Report, 19. Construction Enquirer ‘*L&G launches world’s biggest modular housing factory*’, (25th February 2016)

¹²⁶ John Callcutt, ‘*Review of housebuilding delivery*’, (2007) Department of Communities and Local Government, 165–166

¹²⁷ *Ibid*, (Callcutt), 13

¹²⁸ Wei Pan, Alistair Gibb and Andrew Dainty, ‘Leading UK housebuilders’ utilization of offsite construction methods’, (2008), *Building Research and Information*, 36(1), 56–67, 66

¹²⁹ James Woudhuysen, *Why is construction so backward?*, (James Wiley, London, 2004), xii and 15, describes war-ravaged and disorganised British firms working at the behest of the UK government in a bankrupt country “building 60,000 new pre-fabricated homes, refurbishing 100,000 bombed dwellings and building 34,000 new houses all in fifteen months from April 1945”

¹³⁰ Brenda Vale, *Prefabs: a history of the UK Temporary Housing Programme*, (E&FN Spon, London, 1995), 124–125

¹³¹ Department of Trade and Industry report, ‘*Modern methods of construction in Germany - playing the off-site rule*’, (2004). This was part of a programme of Government reviews looking at innovation overseas for lessons for the UK

aside one hundred hectares of land for some 3,000 self-build homes.¹³² There are minimal rules on what can be built with each plot costing about £50,000 and groups can come together to build an apartment building with each flat costing approximately £70,000 although small units can be brought for £25,000 each.¹³³ The infrastructure is provided by the local authority. There were some moves in this direction to encourage innovation in housebuilding and development prior to 2015 under the UK's coalition government.¹³⁴ For example, "Buildoffsite" has been set up to promote off-site building methods and innovation but it is interesting to note that none of the large UK residential home builders are members.¹³⁵

8.12.9 Machinery of government

Currently housing policy and its implementation is spread over several government departments and agencies (Department for Environment, Food and Rural Affairs, Department for Housing, Communities and Local Government, Department for Business, Energy and Industrial Strategy, Department of Work and Pensions and the Homes and Communities Agency).¹³⁶ This does not enhance "joined-up" government" and there is no leading department with sufficient purpose able or willing to lead on promoting a housing policy. Under the coalition government much of the leadership in this area came from HM Treasury but from my own experience the focus was more on programmes to finance demand rather than on increasing supply. Lyons recommended that the HCA be given the task of investing in housing and infrastructure.¹³⁷

As mentioned earlier, a number of reports have suggested proposals to remedy these issues. These are summarised in the next section.

¹³² The Self Build Portal web-site, '*Almere, Holland*', <http://www.selfbuildportal.org.uk/homeruskwartier-district-almere>, (accessed 29th September 2016)

¹³³ Ibid, ('*Almere Holland*')

¹³⁴ Eric Pickles speech at Homes Event on the need for innovation in housing manufacture, 27th November 2014

¹³⁵ Buildoffsite web-site, <http://www.buildoffsite.com/about/overview/>, (accessed 29th September 2016)

¹³⁶ In January 2018 the Department of Communities and Local Government had "Housing" added to its title

¹³⁷ Supra, note 41, (Lyons), 39-41

8.13 Suggested remedies

8.13.1 Taxation

A number of studies have recommended removing the taxation subsidies on home ownership including the exemptions granted to capital gains exemption and inheritance taxation. Others have gone further and suggested a land valuation tax based on the proposals of the 19th century economist Henry George.¹³⁸ A number of other ideas have also recently surfaced including Professor John Muellbauer's view that the government should acquire land at use value and then arrange for the necessary planning permission.¹³⁹ Tim Leunig has argued that land auctions would lead to higher construction rates, whereby "a local community acquires land without planning permission but which is subsequently designated for housing and therefore benefits from the uptick."¹⁴⁰

8.13.2 Housing development funding

There are several proposals to provide central and local government and housing associations with additional funding to allow a significant increase in house building.¹⁴¹

8.13.3 Planning permission and use of compulsory purchase orders

The main thrust of the proposed changes in this area is to encourage building once planning permission has been granted. They include recommendations that permission not used quickly would be forfeit and that there would need to be evidence of substantial work not merely some ditches dug. If construction is progressing slowly, councils could levy an equivalent to council tax on the land as if the proposed homes had been built. In addition, "compulsory purchase order powers should be strengthened...to make it easier for public

¹³⁸ Financial Times, 'A British property tax that is fit for purpose', (24th September 2014). See Henry George, *Progress and Poverty*, (Robert Schalkenbach Foundation, New York City, 1987)

¹³⁹ 'It is time for the state to jump on the property bandwagon', (Financial Times, 2nd April 2014)

¹⁴⁰ Centre Forum, 'Community land auctions: working towards implementation', (November 2011)

¹⁴¹ Andy Hull, Graeme Cooke and Tony Dolphin, 'Build now or pay later: funding new housing supply', (October 2011), Institute for Public Policy Research Report, 11-14

bodies to acquire land where it is not brought forward and where it is a priority for development.”¹⁴²

8.13.4 A return to the roots of building societies and housing associations

Other possible solutions include a return to the original purpose and values of building societies and housing cooperatives to help finance building and ownership of homes by members. However, this would need to be undertaken on a large scale financed by the issue of bonds backed by government guarantees.¹⁴³

8.14 Conclusion

The pent-up demand for housing (and hence credit) unmatched by housing supply has been created over many years and is growing. This major problem has spread to the rental sector with a significant portion of personal income now devoted to housing costs. This is inefficient in economic terms forming a large misallocation of national resources that could be better used in saving and consumption and hence investment.

In parallel, there has been a consolidation of the land development industry and the growth of a complex and opaque network of land option contracts tying up rights over access to large areas of development land for some five to fifteen years hence. This process has been built on high levels of borrowing and may pose a threat to financial stability but one that appears to have been over-looked by the FPC.

Moreover, it creates the potential for financial instability due to periodic housing price booms fuelled by the provision of extensive credit. Consequently, the only long-term solution to this risk is a big increase in home building. Even though this is a thesis on macroprudential and conduct of business policies this issue cannot be ignored since all the regulatory policy measures provide, at best, only temporary alleviation and not fundamental solutions.

¹⁴² Supra, note 41, (Lyons) , 68

¹⁴³ Philip Callan, Phillip Blond and Edward Douglas, ‘Going to scale: how a National Housing Fund can unlock Britain’s house building capacity’, (November 2016) The ResPublica Trust, 6-9

Chapter 9

Conclusion

This thesis describes the home ownership aspiration as part of the concept of “hope” in the UK. Access to finance to help satisfy this desire may be one of the threads that help to hold society together. In recent history there have been surges in home ownership. This was particularly true at the conclusion of the two World Wars and in the 1930s. To a significant extent this was the result of government policy. In the early 1980s, the latter was responsible for the collapse of social house building and the increased liberalisation of credit. This process was followed by economic crises centered on residential housing in the early 1990s and again in 2007 and 2008. This is reinforced by evidence from a number of jurisdictions supporting the view that financial crises are commonly linked to over-borrowing to fund the acquisition of residential property.

The macroprudential policymakers are faced with the unenviable task of attempting to suppress the means of financing the homeownership aspiration. In benign economic periods this may not prove too much of a challenge. Nevertheless, at other times these policymakers may need to implement policies to restrict the growth of credit in the face of political and social pressures. Depending on the circumstances this may prove both ineffective and a challenge to the will of the macroprudential policymakers and may undermine their legitimacy in the eyes of politicians, the media and citizens.

A systemic financial crisis can result from a number of causes, including those that are episodic such as a war or major operational failure. However, the most common systemic financial crises have at their centre the rapid price inflation of one or more asset classes generated, or at least inflamed, by a surge in the availability of credit. This is true whether it be the schemes of John Law and the Banque Générale Privée, or Jim Slater and Slater Walker Securities and others, in the late 1960s and early 1970s. By their very nature these threats to financial stability emerge very rapidly and are supported by a range of political, media and public “cheer-leaders”. The Economist in 1972 noted that “men of property have been turning stone into gold” in what was described as the “new alchemy”.¹

¹ Quoted in Reid, ‘The secondary Banking crisis 1973-75’, 63, chapt 2, n108

The macroprudential policymaker needs to identify the issues and to act swiftly, effectively and with resolution. However, there are also pressures to chase risk into the next valley resulting in a risk to the policymaker losing focus. They are likely to be acting contrary to the general consensus and those who promote the boom and who talk of “economic paradigm shifts” and “new economic truths”. It is also likely that macroprudential policymakers may need to operate contrary to government intentions and actions and, possibly, monetary policy. The consequences may be to undermine the political legitimacy of the macroprudential policymaker. Moreover, these policies, in attempting to restrain credit growth, may result in the risk migrating elsewhere in the economy and financial system. This process may be supported by fiscal and monetary policy.

All this does not mean that macroprudential policies should be abandoned. The process of identifying systemic risks and use of macroprudential instruments to provide signals of concern to the market are valuable and not to be underestimated. In addition, macroprudential tools of a microprudential nature, such as increased capital and liquidity, are likely to be effective. It is the quantitative instruments that present the greatest concerns. These measures are designed to have a very direct effect on lending to clearly identifiable individuals. The consequence, if these measures are effective, will be expressions of concern by politicians, the media and general public and may result in challenges to the authority and even the legitimacy of the macroprudential policymakers. Moreover the evidence suggests that even if these measures are effective for a short period the market will find ways to avoid their effect by, for example, lending being provided by unregulated, or under-regulated, organisations.

This thesis puts forward the view that these quantitative measures should not be discarded but expectations as to their effectiveness must be lowered. They provide signals to the market, government, the media and the general public of macroprudential concern. It is possible that the government may take steps such as employing fiscal measures to assist in restraining mortgage growth. However, there are other neglected policies and this includes the need for macroprudential policymakers to engage more closely with conduct of business policy.

Conduct of business requirements have the advantages of applying to the function of mortgage lending and not just specific institutions. Moreover, it can be defended since

excessive credit and asset price growth is highly likely to threaten individual new borrowers. This form of regulation is always “on” and does not depend on the timeous reaction of regulators. The approach taken, for example, by the VA may be evidence of this policy working both to protect individual borrowers and, to some extent, financial stability.

Nevertheless, there are significant issues with applying conduct of business policy. There is evidence in the UK of extensive conduct of business failures in areas outside residential mortgage lending. Further, current UK mortgage conduct of business regulation operations are ponderous requiring detailed information from each prospective borrowers with much of this work carried out by intermediaries who are often less in the regulatory spotlight. The fact that these procedures involve borrowers, lenders and intermediaries, all of whom are keen to undertake the transaction as fast as possible may, in a period of booming house prices and loose credit, undermine the effectiveness of the regulations. It is an area which requires close attention by both the conduct of business regulator and the macroprudential policymakers.

To help counter these risks there may be more innovative methods employed to reinforce both conduct of business and macroprudential policies. First, in the field of “fin-tech” there is likely to be considerable data available on all potential mortgage borrowers from, for example, current account transactions, taxation authorities and employers. With the borrowers’ permission, this could be used to assess the affordability of individual loans without them needing to provide any other data. This may reduce the risk of information manipulation and help authenticate the central elements of the affordability calculation thereby making the process more robust.

Second, all regulatory policies involve setting a level of “risk appetite”. The US legislation establishing the Consumer Financial Protection Bureau explicitly does this with the “qualified mortgage”, which exempts mortgages, meeting specific public interest criteria, from being subject to the affordability assessment requirements. This decision has to be made by the legislators since macroprudential policy does not operate in a political vacuum. A public debate about the acceptable level of risk may help strengthen its political legitimacy. However, the concept of assessing and accepting explicit levels of borrowing risk has not been addressed in the UK. It is an aspect which merits consideration.

Finally, it is likely that financial instability will continue to emerge in the UK's residential housing market as borrowers seek to acquire a home of their own in the face of rising prices. This can only be resolved by a political solution which satisfies this unmet aspiration and helps to ensure financial stability.

The broad conclusion of this thesis is the need to encourage those from different regulatory cultures and different disciplines to consult and work closely together and to look, in detail, at lessons from other jurisdictions.

Appendix I: List of abbreviations

AEI - American Enterprise Institute

AMI - Association of Mortgage Intermediaries

AMTPA - Alternative Mortgage Transaction Parity Act 1982

ARM - Adjustable Rate Mortgage

BBA - British Bankers Association (now part of UK Finance)

BIS - Bank of International Settlements

CFPB - Consumer Financial Protection Bureau

CGFS - Committee on the Global Financial System

CMA - Competition and Markets Authority

CML - Council of Mortgage Lenders (now part of UK Finance)

COBS - Conduct Of Business Sourcebook

CRA - Community Reinvestment Act 1977

CSBS - Conference of State Bank Supervisors

DTI - Debt to Income Ratio

EBA - European Banking Authority

ECB - European Central Bank

ECOA - Equal Credit Opportunity Act 1974

ESIS - European Standardised Information Sheet

ESRB - European Systemic Risk Board

FCA - Financial Conduct Authority

FHA - Federal Housing Administration

FPC - Financial Policy Committee

FSA - Financial Services Authority

FSLIC - Federal Savings and Loan Insurance Corporation

FSOC - Financial Stability Oversight Council

GAO - Government Accountability Office

GSE - Government Sponsored Enterprise

HMDA - Home Mortgage Disclosure Act 1975

HOLC - Home Owners' Loan Corporation

IMF - International Monetary Fund

KFI - Key Facts Illustration

LTi - Loan to Income Ratio

LTV - Loan to Value Ratio

MCOBS - Mortgage Conduct Of Business Sourcebook

MMR - Mortgage Market Review

MPC - Monetary Policy Committee

NBER - National Bureau of Economic Research

NDPB - Non-Departmental Public Body

NIM - Net Interest Margin

OCC - Office of the Comptroller of the Currency

OFT - Office of Fair Trading

ONS - Office of National Statistics

PAC - Public Accounts Committee

PCBS - Parliamentary Commission on Banking Standards

PRA - Prudential Regulatory Authority

PRC - Prudential Regulatory Committee

RDR - Retail Distribution Review

RESPA - Real Estate Settlement Procedures Act 1974

RICS - Royal Institution of Chartered Surveyors

ROCE - Return On Capital Employed

SDLT - Stamp Duty Land Tax

TILA - Truth in Lending Act 1968

TRID - TILA/RESPA Integrated Disclosure rule

TSC - Treasury Select Committee

VA - Veterans Administration

Appendix II: List of individuals interviewed and date of meeting

Trade and professional bodies

Eric Leenders (Managing Director, Retail and Commercial Banking at the British Bankers Association) and Paul Chisnall (Executive Director, Financial Policy & Operations at the BBA) - 3rd February 2016

Mark Roberts (Head of Learning Partnership and Regulatory Qualifications at the Chartered Banker Institute) - 26th January 2016

Simon Rubensohn - (Chief Economist at the Royal Institute of Chartered Surveyors (RICS)) - 7th September 2016

Robert Sinclair (Chief Executive of the Association of Mortgage Intermediaries (AMI)) - 15th February 2016

Paul Smee (Director General of the Council of Mortgage Lenders (CML)) - 25th January 2016

Politicians and regulators

Lord (Jeremy) Beecham (Labour Party House of Lords spokesman on housing policy) - 3rd March 2016

Dr Paul Fisher (Deputy Head of Supervision at the Prudential Regulatory Authority and former member of both the Monetary Policy Committee and Interim Financial Policy Committee) - 16th May 2016

John Healey MP (Labour Party Shadow Cabinet Minister for Housing and Planning) - 14th March 2016

Mark Hoban (a former Financial Secretary to the Treasury, 2010-2012) - 5th April 2016

Vasileios Madouros, (Head of Division, Macro-financial Risks Division, Financial Stability, Strategy and Risk, Bank of England) - 23rd November 2016

Sir Paul Tucker - (a former Deputy Governor at the Bank of England with responsibility for financial stability, a member of the Monetary Policy Committee and the interim and full Financial Policy Committee) - 31st October 2016

Lord (Adair) Turner - (former chairman of the Financial Services Authority. Lord Turner became chairman of the FSA a couple of months before the start of the

financial crisis in 2007 and was directly involved in the policy work from 2009 until 2013 on the Mortgage Market Review (MMR)) - 5th July 2016

Nick Wood (Head of Mortgage Policy at the Financial Conduct Authority) - 30th March 2016

Major mortgage lenders

Cyrille Sallé de Chou (Credit Risk Director at Lloyds Bank Mortgages) - 12th April 2016

Paul Denton (Head of Branch Banking and Mortgages and Business Banking at Cooperative Bank) - 4th May 2017

Neil Hornsby (Director of Mortgage Credit Risk at Barclays Bank) - 9th March 2016

Iain Laing (Chief Risk Officer at Nationwide Building Society) - 4th March 2016

Tracie Pearce (Head of Mortgages at HSBC Bank) - 17th May 2016

Nigel Sparrow (Head of Secured Credit Risk at Santander UK) - 28th January 2016

Royal Bank of Scotland/NatWest Bank declined to be interviewed

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